Supreme Court, U.S.
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No. _____

In The

Supreme Court of the United States

CITICORP NORTH AMERICA, INC. & AFFILIATES,

Petitioners,

-v-

FRANCHISE TAX BOARD,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

It is not disputed in this case that a corporation with no physical presence in California is not subject to California's corporate income tax. This tax immunity is derived from the Commerce and Due Process Clauses of the United States Constitution. However, when a nontaxable corporation is engaged in a unitary business with corporations that are taxable in California, under California law a portion of the nontaxable corporation's income is apportioned to California, and such income is then assigned solely to those corporations subject to tax in California. The effect of this tax scheme is to shift income from a corporation that is not taxable in California to corporations that are taxable in California. The questions presented are:

1. Whether a State may tax the income of a corporation, which is constitutionally exempt from tax, through a device that shifts such income to a taxable corporation solely because of the nontaxable status of the corporation that earned such income?

2. Whether a state tax discriminates against interstate commerce in violation of the Commerce Clause of the United States Constitution by increasing a corporation's taxable income solely because that corporation is engaged in a unitary business with one or more corporations that are not taxable by the State?

3. Whether a state tax violates the fair apportionment requirement of the Due Process and Commerce Clauses of the United States Constitution by apportioning

QUESTIONS PRESENTED – Continued

income of a unitary group to a State based on the in-state activities of nontaxable and taxable corporations, and then assigning such income solely to the taxable corporations?

LIST OF PARTIES

The parties are as stated in the caption. Affiliates of Petitioner Citicorp North America, Inc., who were California taxpayers during the 1985-1988 years in issue, are as listed in the Appendix at pages 102a-104a.

RULE 29.6 STATEMENT

Petitioner Citicorp North America, Inc. is a wholly-owned subsidiary of Citicorp, which is a wholly-owned subsidiary of Citigroup Holdings, Inc., which is a wholly-owned subsidiary of Citigroup, Inc. Citigroup, Inc. is a publicly-held corporation.

During the 1985-1988 years in issue, the ownership of Petitioner Citicorp North America, Inc. was as follows: During 1985-1987, Petitioner Citicorp North America, Inc. and its predecessors (Citicorp Industrial Credit, Inc. and Citicorp (USA), Inc.) were wholly-owned subsidiaries of Citicorp Banking Corporation, which was a wholly-owned subsidiary of Citicorp. During 1988, Petitioner Citicorp North America, Inc. was a wholly-owned subsidiary of Citicorp. Citicorp was a publicly-held corporation during all of 1985-1988.

Affiliates of Petitioner Citicorp North America, Inc., who were California taxpayers during the 1985-1988 years in issue, as listed in the Appendix pages 102a-104a, were wholly-owned (directly or indirectly) by Petitioner Citicorp North America, Inc. or its ultimate parent, Citicorp, during the 1985-1988 years in issue.

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PETITION FOR A WRIT OF CERTIORARI

Citicorp North America, Inc. and affiliates respectfully petition for a writ of certiorari to review the judgment of the Court of Appeal of the State of California, First Appellate District, Division One, in this case.

OPINIONS BELOW

The Opinion of the Court of Appeal (Appendix ("App.") 1a-45a) and modification (App. 46a-48a) are officially reported at 83 Cal. App. 4th 1403 (2000) and 84 Cal. App. 4th 670e (2000), respectively. The judgment and statement of decision of the Superior Court of California, City and County of San Francisco (App. 49a-84a) are not officially reported. The California Supreme Court's denial of the Petitioners' petition for review (App. 85a) is not officially reported.

JURISDICTION

The judgment of the Court of Appeal was entered on October 2, 2000. The Supreme Court of California denied Petitioners' petition for review on January 10, 2001. (App. 85a.) The jurisdiction of this Court rests on 28 U.S.C. § 1257(a).

CONSTITUTIONAL PROVISIONS AND OTHER AUTHORITY INVOLVED

The Commerce Clause of the United States Constitution, U.S. Const. art. I, § 8, cl. 3, provides, in relevant part: "The Congress shall have Power . . . [t]o regulate commerce with foreign nations, and among the several States, and with the Indian tribes."

The Due Process Clause of the Fourteenth Amendment to the United States Constitution, U.S. Const. amend. XIV, § 1, provides, in relevant part: "No State shall . . . deprive any person of life, liberty, or property, without due process of law."

Relevant portions of the California statutes, regulations, and other legal authority are set forth in the Appendix at pages 92a-101a.

STATEMENT

Just last term, this Court invalidated a California income tax provision on the ground that a State may not tax indirectly that which it cannot tax directly. *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458, 464-465 (2000), *citing National Life Ins. Co. v. United States*, 277 U.S. 508 (1928). Yet, despite this clear affirmation of this settled axiom of state tax law, California, through a different mechanism, continues to tax through indirect means income that is beyond its reach. In this case, it is undisputed that Citibank (South Dakota), N.A. is not subject to tax by California. However, a portion of Citibank (South Dakota), N.A.'s income is nevertheless taxed under California law by the simple device of assigning its income to taxable corporations that are a part of the same unitary business. California employs two rules, which, in combination, shift income from nontaxable corporations to taxable corporations.

First, California determines the amount of the unitary group's income that is apportionable to California by taking into account the California activities of corporations that are taxable, and corporations that are not taxable under the Due Process and Commerce Clauses. Second, after apportioning to California the income of both taxable and nontaxable corporations, California assigns such income solely to the taxable corporations. The result of these two rules is to shift income attributable to activities of nontaxable corporations to taxable corporations.

Moreover, California shifts income in this manner only when it cannot directly tax a corporation in the

unitary group with income attributable to activities in California.

California's method of determining the taxable income of corporations engaged in a unitary business in this case operates to indirectly tax income of nontaxable corporations that cannot be taxed directly. *See, e.g., Frick v. Pennsylvania*, 268 U.S. 473, 495 (1925) ("[No State] could use [its taxing] power and discretion in accomplishing an unconstitutional end, such as indirectly taxing the transfer of the part of the estate which was under the exclusive jurisdiction of others.").

In addition, California's tax scheme increases the taxable income of a taxable corporation when it engages in a unitary business with a nontaxable corporation, but not when it engages in a unitary business with a taxable corporation. In other words, California increases a corporation's taxable income solely because that corporation is engaged in a unitary business with a corporation that is not taxable in California, *e.g.*, Citibank (South Dakota), N.A. But California does not increase a corporation's taxable income if it is engaged in a unitary business only with other taxable corporations. This rule discriminates against interstate commerce by conditioning a corporation's tax increase on the taxability of its affiliates in California. *See, e.g., Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) (invalidating intangible property tax exemption that varied with extent of corporation's business activity in the State).

Finally, by apportioning to California the unitary group's income based on the California activities of the

entire group (including those activities of nontaxable corporations), but assigning such income only to taxable corporations, California's tax scheme has forsaken any claim that the income apportioned to and taxed by it "reflect[s] a reasonable sense of how income is generated." *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983).

1. Citicorp's Business

The facts of this case are not in dispute. This case involves refund claims filed for the income years ended December 31, 1985 through December 31, 1988. During the years at issue, Citicorp North America, Inc. and its predecessors (Citicorp Industrial Credit, Inc. and Citicorp (USA), Inc.) were wholly-owned subsidiaries of Citicorp, which owned directly or indirectly several hundred foreign and domestic corporations. Citicorp was organized under the laws of Delaware, with its principal place of business in New York. Citicorp engaged in a unitary worldwide financial services business with its affiliates, serving the financial needs of individuals, businesses, governments, and financial institutions.

During the relevant time, Citicorp owned over 550 domestic corporations, approximately 90 of which were California taxpayers. Citicorp North America, Inc. and its California tax-paying affiliates (which are listed at App. 102a-104a), hereinafter referred to collectively as "Citicorp," are the Petitioners in this case.

One of Citicorp's affiliates, Citibank (South Dakota), N.A. ("Citibank South Dakota"), was a national banking association organized under and existing under the laws

of the United States, with its principal place of business in South Dakota. Citibank South Dakota issued Visa and MasterCard credit cards to customers within and without California. Citibank South Dakota did not have any tangible personal property, nor did it have any physical presence, in California. Accordingly, although Citibank South Dakota derived revenue (and income) from California customers, it was not subject to California's corporate franchise or income tax under the California Bank & Corporation Tax Law. (Joint Stipulation ("Stip") ¶ 19, Joint Appendix filed with the Court of Appeal ("JA") p. JA 0099.)

2. California's Taxing Scheme

California imposes a franchise tax measured by net income on corporations for the privilege of doing business in California. Cal. Rev. & Tax. Code §§ 23151, 23151.1. Corporations engaged in a unitary business within and without California determine the "slice" of the group's apportionable "pie" of business income[1] that is fairly attributable to California according to an apportionment formula.

Under California's apportionment formula, the unitary group's business income is multiplied by the unitary group's apportionment percentage, which, during the

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[1] Business income means "income arising from transactions and activity in the regular course of the taxpayer's trade or business. . . . " Cal. Rev. & Tax. Code § 25120(a). On the other hand, "nonbusiness income," which is generally allocated to a particular State, "means all income other than business income." Cal. Rev. & Tax. Code § 25120(d).

years at issue, was the simple average of three fractions (also referred to as "factors"): the taxpayer's in-state property over total property (the "property factor"), its in-state payroll over total payroll (the "payroll factor"), and its in-state sales over its total sales (the "sales factor"). Cal. Rev. & Tax. Code § 25128. During the years at issue, the California payroll, property, and sales of both taxable and nontaxable corporations were includible in the numerator of each factor so that the income apportioned to California included income attributable to the activities of both taxable and nontaxable corporations.[2]

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[2] California recently changed this rule so that the California property, payroll, and sales of nontaxable corporations are excluded from the numerators of the unitary group's property, payroll, and sales fractions. Cal. Code Regs. tit. 18, § 25106.5(c)(7)(B). As a result, unitary income attributable to the California activities of nontaxable corporations is not apportioned to California. This change, if applicable during the years at issue, would have resulted in a full refund of the tax at issue here. However, this change is effective on a prospective basis, and does not apply to tax years ending prior to April 22, 1999. Cal. Code Regs. tit. 18, § 25106.5(g). Although California's current practice ameliorates the constitutional issues raised here on a going-forward basis, the decision of the lower court upholds California's tax scheme for all tax years ending prior to the change and leaves open the option for California to revert to the former rule. In addition, we are aware of four other States (Arizona, Indiana, Kansas, and Utah) that currently follow the rule employed by California during the years at issue. *See Airborne Navigation Corp. v. Ariz. Dep't of Rev.*, No. 395-85-I, 1987 Ariz. Tax LEXIS 34 (1987); Ind. Dep't of Rev., Informational Bulletin No. 12, 1988 Ind. Tax LEXIS 27, June 1988, *revised* Nov. 1993; Ind. Dep't of Rev., Tax Policy Directive No. 6, Ind. St. Tax Rptr. (CCH) ¶ 89-956, June 1, 1992; Kan. Dep't of Rev., Kan. Rev. Rul. 12-91-1, Kan. St. Tax Rptr. (CCH) ¶ 18-735, Feb. 1, 1991; and Utah Admin. Code 865-6F-24.

Because California's franchise tax is imposed on individual corporations and not on the unitary group, once the income apportioned to California is determined, California then assigns such income to individual corporations. *See, e.g.*, Cal. Franchise Tax Bd., Publication 1061, *2000 Guidelines for Corporations Filing a Combined Report* p. 4; *Safeway Stores, Inc. v. Franchise Tax Bd.*, 3 Cal. 3d 745, 478 P.2d 48, 91 Cal. Rptr. 616 (1970). When each of the unitary corporations with California activities is subject to tax, this assignment of income is made on a pro rata basis, based on each corporation's relative California activities. However, when one or more of the unitary corporations with California activities is not subject to tax, California abandons this pro rata assignment of income. Franchise Tax Bd. Notice No. 90-3, June 8, 1990 (App. 86a-91a). Instead, California disregards the California activities of nontaxable corporations, and assigns the California apportioned income *solely* to those corporations that are subject to tax in California. *Id.*

The dispute in this case centers on the apportionment to California of income that is attributable to the California activities of Citibank South Dakota, a nontaxable corporation, and the subsequent assignment of its income solely to taxable corporations that are members of its unitary group.

3. The Claim for Refund

For the years at issue, Citicorp and its affiliates originally filed franchise tax returns based on the position that Citicorp and its affiliates did not engage in a unitary business. Thereafter, Citicorp and its affiliates filed timely

amended returns based on the position that Citicorp and its affiliates were engaged in a unitary business. These amended returns reported an overpayment of tax and constituted Petitioners' refund claims in this case. These refund claims were based, in part, on the position that California could not tax the income of Citibank South Dakota. To avoid taxing the income of Citibank South Dakota, Petitioners asserted that the unitary group's apportionment percentage should be determined by excluding the California sales and property of Citibank South Dakota from the numerators of the unitary group's sales factor and property factor.[3]

Respondent Franchise Tax Board (the "Board") agreed that Citicorp and its affiliates were engaged in a unitary business, but disagreed with Citicorp's computation of the unitary group's sales factor and property factor. The Board recomputed these factors by including Citibank South Dakota's California sales and property in the numerators of the unitary group's sales factor and property factor, respectively.

The Board increased the numerator of the unitary group's sales factor by adding Citibank South Dakota's interest and fees from California credit card customers in the following amounts: $253,377,191 for 1985, $350,520,156 for 1986, $396,321,750 for 1987, and

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[3] In the amended returns, Citicorp also asserted that gain from certain real property sales was not taxable by California. Although Citicorp litigated this issue through the Court of Appeal, it is not seeking review of the lower court's decision on this issue.

$478,974,131 for 1988. (Franchise Tax Bd. Audit Schedules, Joint Trial Exhibit No. 3.) The Board also increased the numerator of the unitary group's property factor by adding Citibank South Dakota's credit card receivables from California customers in the following amounts: $1,364,590,734 for 1985, $1,694,273,284 for 1986, $2,303,098,005 for 1987, and $3,187,824,161 for 1988. (*Id.*)

After increasing the unitary group's California apportionment percentage as described above, the unitary group's income apportioned to California increased by the following amounts: $12,826,406 for 1985, $11,558,073 for 1986, $9,083,509 for 1987, and $14,705,509 for 1988. (*Id.*) Although the Board attributed this income to Citibank South Dakota in its audit schedules, since that corporation was not subject to tax by California, California assigned the additional income solely to Petitioners, corporations subject to tax by California.

4. The Proceedings Below

On March 26, 1998, Petitioners filed suit for refund of taxes and interest in the Superior Court, City and County of San Francisco. Petitioners alleged, in part, that California's method of apportionment and assignment of income in this case violated the Commerce and Due Process Clauses of the United States Constitution by taxing the income of Citibank South Dakota.

(a) **The Superior Court.** By decision dated March 3, 1999, the Superior Court upheld the constitutionality of California's method of determining the taxable income of a corporation engaged in a unitary business. Without attempting to reconcile its holding with the settled authority that a State may not indirectly tax that which it

cannot tax directly, the court reasoned that it was not persuaded by the contention that "inclusion of the property and sales of Citibank (South Dakota), National Association in the numerator of the [property and] sales factor[s] results in the unlawful taxation of a corporation not subject to California tax." (Amended Statement of Decision, JA p. JA 0405.) The court also determined that California's rule satisfied this Court's internal and external consistency tests and therefore did not offend the Due Process and Commerce Clauses. (*Id.* at JA pp. 0409-0410, citing *Container Corp. of Am.*, 463 U.S. at 169.)

(b) **The Court of Appeal.** By opinion dated October 2, 2000, and as modified by court order dated November 1, 2000, the Court of Appeal affirmed the Superior Court's decision. Although Petitioners argued that California was taxing the income of Citibank South Dakota, the court determined that California's tax scheme did not violate the Constitution because California was merely apportioning income, not taxing income. Hence, the court concluded that California's tax scheme resulted in "no legal error":

> However, by considering the California income of Citibank (South Dakota), the FTB is not taxing, but is apportioning income attributable to California. (*Edison Cal. Stores v. McColgan, supra*, 30 Cal. 2d 472, 474-475, 183 P.2d 16.) Taxes are actually imposed only on the corporations that are subject to California's taxing jurisdiction.

(App. 14a.)

(c) **The California Supreme Court.** On January 10, 2001, the California Supreme Court denied Petitioners' petition for review. (App. 85a.)

REASONS FOR GRANTING THIS PETITION

The decision of the California Court of Appeal warrants review by this Court for two compelling reasons. First, the decision of the Court of Appeal is irreconcilable with controlling decisions of this Court, which make clear that a State cannot tax indirectly that which it cannot tax directly. Yet that is precisely the result of California's method of computing taxable income, which shifts income attributable to nontaxable corporations to taxable corporations. This Court's decisions also make it clear that a State may not penalize a corporation simply for affiliating with other corporations which choose to engage in business outside the State. Yet this too is the inexorable effect of California's method of apportionment and assignment of income. Moreover, the lower court's decision is contrary to this Court's decisions which require that a State's method of apportioning income "reflect a reasonable sense of how income is generated." *Container Corp. of Am.*, 463 U.S. at 169.

Second, the Court of Appeal's decision, if allowed to stand, would seriously undermine constitutional restraints on state taxation. If California is permitted to avoid these constitutional restraints by the simple device of assigning income of a nontaxable corporation to a taxable corporation, the constitutional safeguards protecting state taxpayers are meaningless. The significance of the Court of Appeal's holding extends far beyond the more than 40,000 corporations that file income tax returns reporting activities inside and outside California[4] – the

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[4] *See* Cal. Franchise Tax Bd., 1999 Annual Report, Oct. 2000.

world's seventh largest economy.[5] It extends to every multistate taxpayer in every State, which will now be emboldened to tax income that was previously beyond its reach. The extraordinary implications of such a rule, which undermine essential constitutional restraints on state taxation, require review by this Court.

I. THE CALIFORNIA COURT OF APPEAL'S DECISION CONFLICTS WITH SETTLED DECISIONS OF THIS COURT

A. California's Method of Determining California Taxable Income Violates the Well-Settled Rule That a State May Not Indirectly Tax That Which It Cannot Tax Directly

The apportionment of income to California that is related to the in-state activities of nontaxable corporations and the assignment of such income solely to corporations that are subject to tax in California results in the taxation of income that is constitutionally exempt from tax. This conclusion follows from two undisputed propositions.

First, it is undisputed that Citibank South Dakota had no physical presence in California, and therefore was not taxable by California. (Stip ¶¶ 17 and 19, JA p. JA 0099.) This immunity is derived from the Commerce and Due Process Clauses of the United States Constitution. *See Quill Corp. v. North Dakota*, 504 U.S. 298 (1992) and *Nat'l Bellas Hess, Inc. v. Dep't of Rev.*, 386 U.S. 753 (1967).

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[5] Cal. Trade and Commerce Agency, Office of Economic Research, *1998 Gross Product World Ranking, at* http://commerce.ca.gov/california/economy/GSP.html.

Second, the only reason California shifted income attributable to Citibank South Dakota to Petitioners was because California could not tax Citibank South Dakota's income. *See* Franchise Tax Bd. Notice No. 90-3, June 8, 1990 (App. 86a-91a). Conversely, if Citibank South Dakota had been taxable by California, the income attributable to its California activities would not have been shifted to Petitioners. The increase in Petitioners' taxable income is a direct result of Citibank South Dakota's nontaxable status. Therefore, the undeniable result of California's tax scheme is to tax the income of Citibank South Dakota – a nontaxable corporation.

The California Court of Appeal viewed the essential dispute in this case as one of apportionment, *i.e.*, whether the income of the unitary group apportioned to California pursuant to California's apportionment formula was proper. Thus, by determining that the income of the unitary group apportioned to California was proper, the court concluded that "by considering the California income of Citibank (South Dakota), the FTB is not taxing, but is apportioning income attributable to California." (App. 14a.) However, such elevation of form over substance is contrary to a long line of this Court's decisions and has no place in constitutional analysis.[6]

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[6] This Court has made it clear in analyzing constitutional restraints on state taxes that its decisions "consider [ ] not the formal language of the tax statute but rather its practical effect," *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279 (1977); that they evaluate "state taxation based upon its actual effect rather than its legal terminology," *American Trucking Ass'ns v. Scheiner*, 483 U.S. 266, 295 (1987); that they are grounded in "economic realities," *id.*; and that they eschew "magic words or labels," *Ry.*

It is "a just and well-settled doctrine established by this court, that a State cannot do that indirectly which she is forbidden by the constitution to do directly." *Passenger Cases*, 48 U.S. 283, 458 (1849) (plurality opinion). The Court has consistently applied this "great principle" (*id.* at 459) to invalidate state exactions that purport to tax indirectly what the Constitution forbids States from taxing directly. *See, e.g., id.* (striking down an exaction on foreign passengers as a prohibited "duty on tonnage," U.S. Const. art. I, § 10, cl. 3); *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458, 464-465 (2000) (striking down a rule that measures the amount of additional unitary income that becomes subject to taxation (through the reduction of a deduction) by precisely the amount of nontaxable income that the taxpayer has received as an "impermissible tax"); *Guy v. Baltimore*, 100 U.S. 434, 443 (1880) (striking down wharfage fee on vessels carrying out-of-state products "as a mere expedient or device to accomplish, by indirection, what the State could not accomplish by a direct tax"); *Frick v. Pennsylvania*, 268 U.S. 473, 495 (1925) (striking down state estate tax on the ground that "[i]t would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail"); *Lee v. Osceola & Little River Rd. Improvement Dist. No. 1*, 268 U.S. 643 (1925) (striking down state tax scheme that would "accomplish indirectly the collection of a tax against the United States which could not be directly imposed").

Express Agency, Inc. v. Virginia, 358 U.S. 434, 441 (1959), "avoid formalism," *Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358, 373 (1991), and reflect "pragmatism." *Quill Corp.*, 504 U.S. at 310.

California's method of determining taxable income is a paradigmatic example of a State's effort to tax indirectly that which it cannot tax directly. Under California's tax scheme as set forth in Franchise Tax Bd. Notice No. 90-3, June 8, 1990 (App. 86a-91a), if Citibank South Dakota had been taxable in California, its share of the unitary group's apportioned business income in 1985, for example, would have been $12.8 million. However, solely because of Citibank South Dakota's nontaxable status, California determined that its share of the California apportioned income was zero, and instead shifted the $12.8 million to Petitioners. The shifting of income results from (1) the apportionment of the unitary group's income based on the in-state activities of all members of the unitary group, including those in-state activities of nontaxable Citibank South Dakota, and (2) the assignment of such income solely to those corporations that are taxable in California.

This Court has condemned efforts like California's to circumvent constitutional limitations on state taxing power. In *Passenger Cases*, 48 U.S. 283, 458 (1849) (plur. opn. of Grier, J.), this Court considered a Massachusetts statute that required ship captains or owners to pay a tax on each foreign passenger disembarking in the state for the support of foreign paupers. Although no opinion commanded a majority, in a plurality opinion Justice Grier determined the statute violative, *inter alia*, of the provision of the federal Constitution which declares that "No State shall, without the consent of Congress, lay any duty of tonnage," U.S. Const. art. I, § 10, cl. 3, reasoning that:

> It is a just and well-settled doctrine established by this court, that a State cannot do that indirectly which she is forbidden by the Constitution to do directly. If she cannot levy a duty or tax from the master or owner of a vessel engaged in commerce graduated on the tonnage or admeasurement of the vessel, she cannot effect the same purpose by merely changing the ratio, and graduating it on the number of masts, or of mariners, the size and power of the steam-engine, or the number of passengers which she carries. We have to deal with things, and we cannot change them by changing their names. Can a State levy a duty on vessels engaged in commerce, and not owned by her own citizens, by changing its name from a 'duty on tonnage' to a tax on the master, or an impost upon imports, by calling it a charge on the owner or supercargo, and justify this evasion of a great principle by producing a dictionary or a dictum to prove that a ship-captain is not a vessel, nor a supercargo an import?

Passenger Cases, 48 U.S. at 458.

Similarly, in *Frick v. Pennsylvania*, 268 U.S. 473 (1925), a Pennsylvania statute levied an estate tax on the transfer by will of valuable tangible personal property owned by a Pennsylvania domiciliary but having its actual situs in New York. This Court held that Pennsylvania had no extraterritorial jurisdiction to tax such personal property and thus concluded that the tax was invalid under the Due Process Clause of the Fourteenth Amendment. Pennsylvania argued that even if it taxed only the property that the decedent owned in Pennsylvania, it could take as a basis for calculating that tax the combined value of the

decedent's property in Pennsylvania and New York. Rejecting the argument, this Court reasoned:

> [T]his was but the equivalent of saying that it was admissible to measure the tax by a standard which took no account of the distinction between what the State had power to tax and what it had no power to tax, and which necessarily operated to make the amount of the tax just what it would have been had the State's power included what was excluded by the Constitution. This ground, in our opinion, is not tenable. It would open the way for easily doing indirectly what is forbidden to be done directly, and would render important constitutional limitations of no avail.

Frick, 268 U.S. at 494-495.

The tax schemes invalidated in *Passenger Cases* and *Frick* are indistinguishable, in effect, from the scheme at issue here. In each case, a tax immunity is circumvented so that the tax collected by the State is unchanged regardless of whether a tax immunity applied. As this Court once put the matter, " 'a tax on sleeping measured by the number of pairs of shoes you have in your closet is a tax on shoes.' " *Trinova Corp. v. Mich. Dep't of Treasury*, 498 U.S. 358, 374 (1991). Accordingly, a tax on Petitioners measured by the income of Citibank South Dakota is a tax on Citibank South Dakota.

B. California's Rule of Increasing the Income of Corporations that Affiliate with Nontaxable Corporations Is Indistinguishable from the State Taxing Scheme Condemned in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996)

The rule prohibiting taxes that discriminate against interstate commerce is a central tenet of this Court's Commerce Clause doctrine. *See, e.g., Or. Waste Sys., Inc. v. Dep't of Envtl. Quality*, 511 U.S. 93 (1994). No aspect of this doctrine is more firmly established than the principle that a State may not favor in-state over out-of-state entities. By increasing a corporation's taxable income solely because it engages in a unitary business with a nontaxable corporation, California violates this settled principle of Commerce Clause jurisprudence.

Under California's tax scheme, a taxable corporation is required to pay the tax on the income of a nontaxable corporation. By increasing a corporation's taxable income solely because it has affiliated with a nontaxable corporation, California "penalizes" the corporation for affiliating with a nontaxable corporation. Under California's tax scheme, a corporation's taxable status is dependent on the level of activity it engages in in the State. Thus, the tax "penalty" in this case is directly dependent on the level of in-state activity of affiliated corporations. In this respect, California's tax scheme is virtually identical to the North Carolina tax scheme invalidated by this Court in *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996).

In *Fulton*, the Court considered a North Carolina intangible property tax as applied to taxpayers who owned corporate stock. The tax was imposed at the rate

of 0.25 percent of the fair market value of the stock. The value of the stock assessed under the tax, however, was reduced by a percentage equal to the percentage of the corporation's income subject to tax in North Carolina. Under this regime, if the stock was issued by a corporation doing all of its business in North Carolina, a 100 percent reduction of the value of the stock would be allowed; if the stock was issued by a corporation doing 50 percent of its business in North Carolina, a 50 percent reduction of the value of the stock would be allowed; and if the stock was issued by a corporation doing none of its business in North Carolina, no reduction of the value of the stock would be allowed.

This Court had no hesitation in branding North Carolina's taxing scheme as "facially" discriminatory:

> A regime that taxes stock only to the degree that its issuing corporation participates in interstate commerce favors domestic corporations over their foreign competitors in raising capital among North Carolina residents and tends, at least, to discourage domestic corporations from plying their trades in interstate commerce.

Id. at 333.

California's tax scheme suffers from precisely the same constitutional infirmity. It increases a taxpayer's taxable income only when a unitary affiliate with California activities is not taxable. Thus, just as in North Carolina, the taxpayer is not penalized when its affiliates engage in sufficient business activity in the State so that it is subject to tax. If the affiliate's in-state activities are insufficient to confer jurisdiction to tax, the corporation's taxable income increases. In this respect, this Court's

reasoning in *Fulton* should apply with even greater force in this case because a taxpayer's tax liability does not increase "only to the degree" that the affiliate participates in interstate commerce; rather, 100 percent of the affiliate's income is shifted to a taxpayer as soon as the affiliate obtains nontaxable status. Accordingly, the California tax scheme "facially discriminates against interstate commerce." *Id.*

C. California's Tax Scheme Violates the Fair Apportionment Standard of *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977)

The essential requirement of a State's apportionment formula, under both the Due Process and Commerce Clauses, is that it must be fair. *Container Corp. of Am. v. Franchise Tax Bd.*, 463 U.S. 159, 169 (1983). In evaluating the fairness of an apportionment formula, this Court has advised that a tax will be fairly apportioned only if it is both "internally consistent" and "externally consistent." *Okla. Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 185 (1995); *Goldberg v. Sweet*, 488 U.S. 252, 261 (1989). External consistency, the aspect of fair apportionment relevant here, "looks . . . to the economic justification for the State's claim upon the value taxed, to discover whether the tax reaches beyond the portion of value that is fairly attributable to economic activity within the taxing State." *Jefferson Lines, Inc.*, 514 U.S. at 185.

California's tax scheme violates the fair apportionment requirement by apportioning nontaxable income to California and then assigning that income solely to taxable corporations. By doing so, California has not only

shifted the income attributable to a nontaxable corporation to a taxable corporation, it has also shifted the apportionment factors of the nontaxable corporation to those corporations that are taxable. As a result, the income of each taxable corporation no longer reflects its own activities; rather, it also reflects the activities of the nontaxable corporation. For this reason, California has forsaken any claim that "the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated." *Container Corp. of Am.*, 463 U.S. at 169.

In addition, the income apportioned to California is "grossly distorted" and "out of all appropriate proportion" to Citicorp's activities in California, since such income includes income attributable to the California activities of a nontaxable corporation. *See Norfolk & W. Ry. Co. v. State Tax Comm'n*, 390 U.S. 317, 326 (1968); *Hans Rees' Sons, Inc. v. North Carolina*, 283 U.S. 123 (1931).

II. IF LEFT IN PLACE, THE DECISION OF THE COURT OF APPEAL WILL SERIOUSLY UNDERMINE CONSTITUTIONAL RESTRAINTS ON STATE TAXATION

The decision below poses a serious threat to constitutional restraints on state taxation by allowing a State to evade those restraints through the simple expedient of shifting income from a nontaxable corporation to a taxable corporation. If left undisturbed, California's tax scheme will provide a roadmap for circumvention of the most basic of constitutional limitations embedded in this Court's doctrine – namely, the bar against taxing income

that the State is prohibited from taxing. If a State can increase its income subject to tax by the transparent device of shifting income from a nontaxable corporation to a taxable corporation, then the bar on taxing such nontaxable corporation is illusory. Yet that is precisely what California has done.

The impact of the Court of Appeal's decision is not merely theoretical. More than 40,000 corporations have filed income tax returns reporting activities inside and outside California, and thus are potentially subject to the tax scheme at issue. In addition, California is the world's seventh largest economy[7] – with corporate franchise tax revenues alone of more than $5 billion.[8] Even if the impact of the decision below were limited to California, it would warrant this Court's review because of the enormous effect it will have on multistate taxpayers, the overwhelming majority of which do business in California.

But the impact of the Court of Appeal's decision is not so limited. If the decision below is left undisturbed, it will pave the way for every State to avoid the constitutional limitations on its taxing powers. The decision below, after all, stands for a proposition of astonishing breadth: A State may constitutionally increase a taxpayer's income merely by shifting income from a nontaxable corporation to a taxable corporation, even where there is no evidence that such income was attributable to the taxable corporation's in-state activities. Moreover, the States are well aware of this issue – as noted earlier, at

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[7] *Supra*, note 5.

[8] Cal. Franchise Tax Bd., 1999 Annual Report, Oct. 2000.

least four other States have adopted tax schemes similar to that at issue here, and California's rule has been the topic of frequent discussion in the state tax literature.[9]

In short, the decision below has implications not only for California, but for every State and for every taxpayer that conducts business across state lines. Unless quickly repudiated, the California Court of Appeal's decision will

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[9] *See, e.g.*, Eugene F. Corrigan, *Finnigan's Wake or Joyce's? The Application of the Unitary Principle to Combined Groups*, Journal of California Taxation, Fall 1989, at 5; Eugene F. Corrigan, *Computing the Sales Factor in Unitary Combination States: Finnigan II Displaces Joyce*, Interstate Tax Report, Vol. 8, No. 6, 1990 at 7; Ruurd G. Leegstra & Fred O. Marcus, *Joyce Overturned – Justice Denied?*, Journal of California Taxation, Summer 1990, at 5; Pierre Vogelenzang, *Second-Stage Apportionment of Unitary Income*, *Tax Notes*, Oct. 15, 1990, at 335; Jerome R. Hellerstein & Walter Hellerstein, *The Finnigan Case: A Reply to Vogelenzang's 'Second Stage Apportionment of Unitary Income,'* Tax Notes, May 20, 1991 at 891; Eugene F. Corrigan, *A Second Quill in the States' Quiver? Possible Use Tax Jurisdiction Ramifications of Finnigan II*, State Tax Notes, Feb. 3, 1992, at 165; Eugene F. Corrigan, *Finnigan Faces a California Challenge*, *State Tax Notes*, Apr. 5, 1993, at 784; Lenny Goldberg, *Finnigan's Wake? FTB Moves to Adopt Joyce Apportionment Rule*, State Tax Notes, Mar. 29, 1999, at 978; Lenny Goldberg, *FTB Takes Final Action on Joyce Rule*, State Tax Notes, July 12, 1999, at 80; Kathleen K. Wright, *The Huffy Affair – And Joyce Versus Finnigan*, State Tax Notes, July 12, 1999, at 107; Ruurd G. Leegstra, *Re-Joyce – Rejoice!*, State Tax Notes, Jan. 3, 2000, at 65; Fred O. Marcus & Eric C. Fader, *It's Joyce Again in California! Dispute Remains Over Retroactive Application*, Multistate Tax Report, Apr. 28, 2000, at 217; Fred O. Marcus & Eric C. Fader, *California's Joyce Rule Examined*, State Tax Today, May 24, 2000, at 101-04; and Robert M. Kozub, *California State Board of Equalization Readopts Joyce Rule*, State Tax Notes, Sept. 4, 2000, at 621.

allow California to tax income that is beyond its constitutional reach, and is likely to embolden other states to follow California's lead. In these circumstances, this Court should grant review of the decision below.

CONCLUSION

For the reasons set forth above, the petition for certiorari should be granted.

Respectfully submitted,

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APPENDIX A

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL OF THE STATE OF CALIFORNIA

FIRST APPELLATE DISTRICT

DIVISION ONE

CITICORP NORTH AMERICA, INC. & AFFILIATES, Plaintiffs and Appellants, v. FRANCHISE TAX BOARD, Defendant and Respondent.	A086925 (San Francisco County Super. Ct. No. 990474)

(Filed Oct. 2, 2000)

Citicorp North America, Inc. (Citicorp) and its affiliates appeal from a decision of the superior court in favor of the Franchise Tax Board (FTB) in this action for refund of corporate franchise taxes.[1] We affirm the trial court's judgment. The FTB properly included the California sales of Citicorp's Citibank (South Dakota), a member of the unitary corporate group, in calculating the amount of income apportionable to California operations under the rule in effect at the time Citicorp filed its amended

[1] References to "Citicorp" include the members of the unitary group.

returns. We also reject Citicorp's contention that the gain on sales of real property, including its corporate headquarters, was not business income.

BACKGROUND

The facts of this case are not in dispute. The parties submitted a joint stipulation and exhibits to the trial court regarding the relevant facts, which are summarized as follows. Citicorp is a Delaware corporation, with its principal place of business in New York. Citicorp and its affiliate corporations are part of a worldwide financial services organization. Citicorp directly and indirectly owns several hundred foreign and domestic corporations that offer lending, deposit taking, investment management and other traditional financial and banking services. At the relevant time Citicorp owned over 550 domestic corporations, 88 of which are California taxpayers. The two disputed issues in this appeal are the FTB's allocation of California destination sales by Citicorp's Citibank (South Dakota) affiliate and characterization of the gain on sales of four properties as "business income."

Taxes Attributable to Sales by Citibank (South Dakota)

For the tax years ending December 31, 1985 through December 31, 1988, Citicorp and its affiliates filed separate company franchise tax returns in California. In 1992 and 1993, the Citicorp group filed amended returns requesting refunds for the challenged years, taking the position that Citicorp was conducting a worldwide unitary business, and that the combined franchise tax must

be computed on a unitary basis. FTB has not challenged Citicorp's position regarding its unitary business.

Prior to Citicorp's filing of the amended returns, the State Board of Equalization (SBE) issued its two decisions in *Appeal of Finnigan Corporation* (*Appeal of Finnigan Corporation* (Aug. 25, 1988) [1986-1990 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 401-653, [*Finnigan I*]; opn. on petn. for rehg. (Jan. 24, 1990) [1986-1990 Transfer binder] Cal.Tax Rptr. (CCH) ¶ 401-797 [*Finnigan II*].) Changing the way in which an out-of-state affiliate's sales are apportioned to determine the income of the unitary business, *Finnigan* overruled the precedential decision of *Appeal of Joyce, Inc.* which had guided allocation of corporate franchise taxes in California for 22 years. *Finnigan* was applied retroactively in the subsequent case of *Appeal of the NutraSweet Company* (Oct. 29, 1992) [1992-1993 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 402-524. (*Appeal of Joyce, Inc.* (Nov. 23, 1966) [1966-1971 Transfer Binder] Cal.Tax Rptr. (CCH)¶ 203-523; Cal. Franchise Tax Bd., Notice No. 90-3 (June 8, 1990) [1991-1992 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 401-820 (Notice No. 90-3).)

Citicorp's amended returns constituted timely claims for refund. It is undisputed that Citibank (South Dakota), a South Dakota affiliate that handles VISA and MasterCard credit card business, was a member of the unitary group for the years in question. It is also undisputed that Citibank (South Dakota) had no physical presence in California, its only office was located in South Dakota, and it was not subject to California's corporate franchise or income tax during the years in question. Citibank (South Dakota) had numerous credit card customers in California. In calculating its California sales, Citicorp

excluded California sales by Citibank (South Dakota), in accordance with the holding in the overruled *Appeal of Joyce, Inc.* decision.

FTB audited the amended returns and recalculated the California sales to include the California sales by Citibank (South Dakota), pursuant to the rule of *Finnigan.* The FTB's calculation reduced the amount of the refund due to Citicorp. The question presented to the trial court was whether application of the *Finnigan* rule was appropriate and constitutional.

Taxes Attributable to Sales Characterized as Business Income

The second issue involves characterization of the income from the sale of corporate properties. With respect to the year ended December 31, 1987, the FTB concluded that gains from the sale of four parcels of real property constituted business income and should be included in Citicorp's business income subject to apportionment in California. The four properties included the corporate headquarters of a wholly owned subsidiary, a nine-story office building partially occupied by corporate personnel, a 59-story building known as Citicorp Center, and a residence and land in Osaka, Japan.

During the income years at issue and prior to the sale of the properties, Citicorp included the original cost of the four properties in the denominator of the property

factors used to determine business income in an apportionment formula.[2] Citicorp also included any rental income and expenses associated with the management of the buildings in determining its business income attributable to California sources. However, when it filed its amended return, Citicorp characterized the gain on the sale of these properties as nonbusiness income. In its audit of Citicorp's amended return and request for refund, the FTB recharacterized the gain on sale of these properties as business income.

On October 22, 1997, Citicorp filed a suit for refund in the superior court. The complaint contained six causes of action. The first through fourth causes of action alleged that inclusion of the sales of Citibank (South Dakota)

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[2] The apportionment formula divides business income using three fractions, called factors, that are a representative source of the taxpayer's income from property, including certain sales of property, payroll and sales. The formula can be described as follows. "The numerator of each factor is the dollar amount of the particular category that is attributed to the taxing jurisdiction, and the denominator of each factor is the total dollar amount of the same category for all jurisdictions. [Fn. omitted.] The three fractions are added together and the sum divided by three. The resulting fraction, often expressed as a percentage, is then multiplied by that amount of the tax base that has not been specifically allocated. The product so determined is the amount of income attributed to the state by the taxing formula." (Boren, *Equitable Apportionment: Administrative Discretion and Uniformity in the Division of Corporate Income for State Tax Purposes* (1976) 49 So.Cal.L.Rev. 991, 995-996, & fn. 22.) After the tax years at issue in this case, the statutory formula was changed in ways that do not impact this appeal. (Rev. & Tax Code, § 25128.)

violated the Uniform Division of Income For Tax Purposes Act (UDITPA, Rev. & Tax. Code, § 25120 et seq.) and the due process and equal protection clauses of the United States and California Constitutions, and the commerce clause of the United States Constitution.[3] The fifth cause of action alleged that the gains from sales of the buildings were nonbusiness income under the applicable statutes and regulations. The sixth cause of action was resolved between the parties and no issue regarding it is raised in this appeal.

On March 3, 1999, the court issued its amended statement of decision, deciding the matter in favor of the FTB. Citicorp and its affiliates appealed.

DISCUSSION

Citicorp challenges the FTB's inclusion of the property and sales of the South Dakota affiliate in the numerator of the formula used to apportion the group's California income. Citicorp argues that including property and sales of the South Dakota affiliate is inconsistent with the Revenue and Taxation Code and the unitary method of taxation in that it ignores separate business identities. Citicorp also contends that the FTB's position violates the holding of *Current, Inc. v. State Bd. of Equalization* (1994) 24 Cal.App.4th 382, by taxing nontaxable property of the out-of-state affiliate.[4] Citicorp argues that

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[3] Unless otherwise indicated, all statutory references are to the Revenue and Taxation Code.

[4] Corporations Code section 150 defines "affiliate" as follows. "A corporation is an 'affiliate' of, or a corporation is

application of the rule of *Finnigan* violates the UDITPA principal of uniformity, because other states did not adopt it. Citicorp urges this court to ignore *Finnigan* in light of the FTB's initial opposition to that rule, and the SBE's overruling of *Finnigan* and the prospective return to the old rule of *Joyce* after the judgment in this case.

Citicorp's second challenge is to the characterization of the four sales of real property as business income. Citicorp argues that the resulting gains are not business income under a transactional test and that the trial court erred in applying a separate functional test of business income. Citing the FTB's own regulations, Citicorp argues that the challenged gains are not business income under any test. Finally, Citicorp contends that it is unconstitutional to tax the gain on these sales. We review Citicorp's arguments in the order presented and affirm the judgment of the trial court.

Background of Franchise Taxation of Unitary Businesses

This case involves apportionment of the income of a unitary business. A unitary business is one that receives income "from or attributable to sources both within and without the state. . . . "[5] (§ 25101.) If a unitary business

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'affiliated' with, another specified corporation if it directly, or indirectly through one or more intermediaries, controls, is controlled by or is under common control with the other specified corporation." According to exhibits submitted in this matter, the affiliates in this action are owned directly or indirectly more than 50 percent by Citicorp.

[5] A unitary business is generally defined as two or more business entities that are commonly owned, and integrated in a

exists, taxes are apportioned by formula to allocate to California for taxation, "its fair share of the taxable values of the taxpayer. . . . " (*Butler Brothers v. McColgan* (1941) 17 Cal.2d 664, 667-668.) In calculating corporate franchise taxes of a unitary business, the FTB apportions income generated by the unitary business based on the relationship of the combined income to the income derived from California sources.

The California statutory apportionment formula takes into account three fractions. The first fraction, known as the "property factor" has a numerator of the average value of California real and tangible personal property and a denominator of all real and tangible personal property. (§ 25129.) The second fraction is the "payroll factor," which is the total amount of compensation paid by the taxpayer in California divided by the total

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way that transfers value among the affiliated entities. In *Butler Brothers v. McColgan, supra,* 17 Cal.2d 664, 668, our Supreme Court stated that the presence of the following three factors is sufficient to establish the existence of a unitary business: (1) unity of ownership; (2) unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) unity of use in its centralized executive force and general system of operation. In *Edison California Stores v. McColgan* (1947) 30 Cal.2d 472, the court proposed an alternative standard that stated if the operation of the portion of the business within the state is dependent upon or contributes to the operation of the business outside the state, its operations are unitary. (See also *Container Corp. v. Franchise Tax Bd.* (1983) 463 U.S. 159, 179, noting three elements of a unitary business: (1) functional integration; (2) centralized management; and (3) economies of scale.)

compensation paid everywhere. (§ 25132.) The third fraction is the "sales factor," which is the total sales in California divided by the "total sales of the taxpayer everywhere during the income year." (§ 25134.) Each fraction has a numerator representing the amount attributable to California and a denominator representing the worldwide amount.[6] The statutory scheme of apportionment is derived from the Uniform Division of Income for Tax Purposes Act (UDITPA), which has been adopted by over 20 states and was enacted in California in 1966. Sections 25134 and 25135 are substantially identical to UDITPA sections 15 and 16. The expressed general purpose of UDITPA is to standardize state corporate income tax laws and "to make uniform the law of those states which enact it." (§ 25138.) If each state applied the apportionment formula in the same way, the sum of the amounts of income attributed to each taxing state would equal the tax base of the corporation and provide uniform fairness.

The issue in apportionment of sales is how to properly attribute income among all of the states in which a business operates. Sales of tangible personal property are generally attributed to the state of destination if the taxpayer is subject to taxation in that state. If the taxpayer's only presence in that state is its customers, sales are generally "thrown back," or considered for apportionment in its state of origin.[7] Shortly after California's

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[6] See footnote 2, *supra*.

[7] The version of section 25135 in effect prior to December 1, 2000 (the "throwback rule") provides for inbound and outbound sales: "Sales of tangible personal property are in this

adoption of UDITPA, the SBE issued its opinion in *Appeal of Joyce, Inc., supra,* Cal.Tax Rptr. (CCH) ¶ 203-523; Notice No. 90-3.) In *Joyce,* the SBE determined that Public Law No. 86-272 (Sept. 14, 1959) 73 Stat. 555 (15 U.S.C. § 381 et seq.) prevented the state from considering income from a member of a unitary group where the individual member's sole contact in California was sales representatives who solicited, but could not accept orders in the state.[8] *Joyce* involved an Ohio corporation and its California subsidiary, both of which sold shoes in California. Only the subsidiary was subject to taxation in California. The SBE concluded that inbound sales by the parent company, which was not subject to tax in California, could not be included in the allocation formula for purposes of calculating the sales factor, even though another member of

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state if any of the following apply: (1) The property (including unprocessed timber) is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale. [¶] (2) The property (including unprocessed timber) is shipped from an office, store, warehouse, factory, or other place of storage in this state and (A) the purchaser is the United States government or (B) the taxpayer is not taxable in the state of the purchaser." Application of the rule is limited by the requirements of federal law regarding tax on activities in interstate commerce. (See 15 U.S.C. § 381, subd. (a).)

[8] Public Law No. 86-272 protects an out-of-state corporation from state income taxes if its only activity in the state is: "the solicitation of orders . . . for sales of tangible personal property, which orders are sent outside the [s]tate for approval or rejection, and, if approved, are filled by shipment or delivery from a point outside the [s]tate. . . . " (15 U.S.C. § 381, subd. (a).)

the group was taxable in California. *Joyce* was the rule in California from 1966 until 1988.

In 1988 the SBE adopted a new method of attributing income for members of unitary groups. *Appeal of Finnigan Corporation, supra,* Cal.Tax Rptr. (CCH) ¶ 401-653 [*Finnigan I*], a case that was the factual mirror image of *Joyce,* involved two California corporations with outbound sales to other states. Only one of the corporations had a nexus with the foreign state and the FTB threw back the sales of the second corporation to California. The SBE, however, agreed with the taxpayer that outbound sales to non-California destinations made by a California member of a unitary group should not be thrown back to California for inclusion in the sales factor formula where another member of the group had a nexus in the foreign state.[9] This change from *Joyce* was based on the fact that one member of the unitary group was taxable in the destination state, even though the individual seller was not. Under *Joyce,* if the individual seller had not been subject to tax in the foreign state, its foreign sales would have been "thrown back" to the state of origin. The SBE

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[9] The actual issue in *Finnigan I* was application of the throw back rule, which is not at issue in this case. As explained in *Finnigan I,* the general rule is that sales of tangible personal property are assigned to the state of destination of the goods for purposes of the sales factor of the apportionment formula. "However, such sales are assigned, or 'thrown back,' to California if the property is shipped from this state and the 'taxpayer is not taxable in the state of the purchaser' (the 'throw back' rule)." (*Appeal of Finnigan Corporation, supra,* Cal.Tax Rptr. (CCH) ¶ 401-653.) The result in *Finnigan I* was that the affiliate's sales to foreign states were not thrown back to California because a member of the group was taxable in the foreign state.

reached its new result by interpreting the word "taxpayer" in this portion of the Revenue and Taxation Code to mean all members of a unitary group. In addition, in *Joyce* the SBE had been concerned that the federal statute (15 U.S.C. § 381, subd. (a)) would be interpreted in an expansive manner to restrict taxation of unitary groups. However, such legitimate fears were subsequently proved unfounded. (*Finnigan II*, opn. on petn. for rehg., *supra*, Cal.Tax Rptr. (CCH) ¶ 401-797; see, e.g., *Brown Group Retail, Inc. v. Franchise Tax Bd.* (1996) 44 Cal.App.4th 823.)

On January 24, 1990, the SBE issued its opinion on rehearing in *Finnigan II*. (*Appeal of Finnigan Corporation*, opn. on petn. for rehg., *supra*, Cal.Tax Rptr. (CCH) ¶ 401-797 [*Finnigan II*].) The SBE noted that it had not expressly overruled *Joyce* in *Finnigan I* because the factual context was different. However, the SBE noted criticism of the *Joyce* rule and specifically overruled the case.

In 1990, the FTB issued Notice No. 90-3, announcing that the rule of *Joyce* no longer applied, and that the FTB would implement the decision in *Finnigan*. Neither the *Finnigan* opinions nor Notice No. 90-3 specifically discuss retroactive application of *Finnigan*, but the decision was applied retroactively in the *NutraSweet* case. (*Appeal of the NutraSweet Company, supra*, Cal.Tax Rptr. (CCH) ¶ 402-524.)

The SBE's 1992 decision in *NutraSweet* involved facts similar to the facts of *Joyce*. In *NutraSweet*, sales into California by a Puerto Rico subsidiary of a unitary group were attributed to California for purposes of the sales

factor because a part of the group was taxable in California, even though the actual seller was not. The *NutraSweet* decision applied the *Finnigan* rule to tax years 1974 through 1977. The *NutraSweet* rule was in effect and applied to Citicorp in this case when Citicorp filed amended returns seeking refunds.[10]

In summary, under the *Joyce* rule, income is only attributable to California for purposes of the allocation formula, if the affiliate generating the income has a nexus in the state. Under *Joyce*, the income of Citibank (South Dakota) would not be attributed to California. Under the *Finnigan/NutraSweet* rule, the FTB in determining the proportion of the combined income in California, treats all affiliates as a unitary taxpayer and includes income generated in California from affiliate corporations located outside the state, if any member of the group is taxable in the state, even though the affiliate itself is not taxable. Citicorp argues that *Joyce* supplies the appropriate rule, while the FTB follows *Finnigan*.

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[10] One month after the trial court in this case filed its judgment, the SBE issued its decision in *Huffy*. (*Appeal of Huffy Corporation* (April 22, 1999) Cal.Tax Rptr. (CCH) ¶ 403-031.) In *Huffy*, the SBE reexamined *Finnigan* in light of its poor reception by other states, and rejected the *Finnigan/Nutrasweet* rule in favor of the *Joyce* rule. "Our *Finnigan/Nutrasweet* interpretation of Revenue and Taxation Code section 25135 remains inconsistent with that of nearly all other states that have comparable legislation and should not be adhered to." (*Appeal of Huffy Corporation, supra*, Cal.Tax Rptr. (CCH) ¶ 403-031.) In light of the general reliance by taxpayers on the *Finnigan* rule, the SBE determined that its decision to return to the rule of *Joyce* would be applied only on a prospective basis to tax years beginning on or after the date of the *Huffy* opinion.

Finnigan Is Consistent With Unitary Principles

Citicorp argues that the result in *Finnigan* twists the unitary method in a manner that allows the state to tax the income of a non-taxpaying entity such as its South Dakota affiliate. However, by considering the California income of Citibank (South Dakota), the FTB is not taxing, but is apportioning income attributable to California. (*Edison California Stores v. McColgan, supra,* 30 Cal.2d 472, 474-475.) Taxes are actually imposed only on the corporations that are subject to California's taxing jurisdiction. Our Supreme Court has approved apportionment formulas as an appropriate method of determining the California income of a unitary group of corporations. (*Ibid.* [parent and 15 subsidiary corporations, only one of which was qualified in California, properly subject to three-part allocation formula].) The United States Supreme Court held that computing income of a unitary business that is allocable to one state by use of a reasonable formula does not result in an impermissible tax on extraterritorial values. (*Id.* at p. 483, citing *Butler Brothers v. McColgan* (1942) 315 U.S. 501, 507 and *Great Atlantic & Pac. Tea Co. v. Grosjean* (1937) 301 U.S. 412, 427 ["It is not a denial of due process to adjust such license taxes as are here involved to meet the local evil resulting from business practices and superior economic power, even though those advantages and that power are largely due to the fact that the taxpayer does business not only in Louisiana, but in other states."].)

When a unitary business is established, a taxpayer challenging the FTB's apportionment method must show

the "formula allocation method was arbitrary and unreasonable." (*Edison California Stores v. McColgan, supra,* 30 Cal.2d at p. 482.) Although Citicorp argues that *Edison* is irrelevant here because it predates the enactment of the UDITPA, the principles of *Edison* apply to Citicorp's argument. Regardless of the date of enactment of the present law, *Edison* is a clear response to Citicorp's claim that consideration of the out-of-state affiliate's California activity results in extraterritorial taxation.[11] "The ascertainment of income by the apportionment method is not necessarily a disregard of the corporate entity nor an extension of the provisions of the statute by implication. Formula allocation is merely a method of ascertaining the true income attributable to the plaintiff's business. . . . " (30 Cal.2d at p. 481.) *Finnigan*'s methodology is consistent with accepted principles of taxation of a unitary business.

The *Finnigan* Interpretation of "Taxpayer" Is Not Unreasonable

Citicorp argues that the trial court stated a "remarkable" proposition without legal support when it upheld the SBE's determination in *Finnigan* that the context of section 25135 required the SBE to interpret "taxpayer" as applying to the entire unitary group for purposes of

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[11] Citicorp argues that *Edison* is irrelevant to a discussion of apportionment rules under UDITPA because *Edison* predates UDITPA. *Edison*, however, discussed a three-factor apportionment formula like that subsequently used in UDITPA. Use of the formula in California dates back to inception of the corporate franchise tax in 1929. (Keesling & Warren, *California's Uniform Division of Income for Tax Purpose Act Part II* (1968) 15 UCLA L.Rev. 655.)

application of the throwback rule in *Finnigan*. The referenced portion of the trial court's opinion discussed the *Finnigan* interpretation of the word "taxpayer" for purposes of section 25135, as referring to the unitary group, rather than the individual affiliate. Citicorp's position is that the sales of its South Dakota affiliate cannot be included in the California portion of the allocation formula because the affiliate is not subject to tax in California.

In *Finnigan*, the SBE considered out-of state sales by a California subsidiary, the opposite of the situation in this case. In *Finnigan*, the FTB had thrown back outbound sales to California because the selling subsidiary was not taxable in the foreign states, even though other members of the group were. The SBE accepted the taxpayer's argument that it should not interpret the throwback rule on a separate company basis when it interpreted the word "taxpayer" in all other instances involving unitary groups to mean all corporations in the unitary group. Citicorp argues that "taxpayer" means a single company, and that it was error to assign the South Dakota sales here when the single company making the sale is not subject to tax here.[12]

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[12] We note that section 25102, captioned "Persons owned or controlled by same interests; combined report; combination or allocation of income and deductions," provides for treating a unitary group as a single entity: "In the case of two or more persons, as defined in Section 19 of this code, owned or controlled directly or indirectly by the same interests, the Franchise Tax Board may permit or require the filing of a combined report and such other information as it deems necessary and is authorized to impose that tax due under this

As the trial court here pointed out, section 23030 provides: "Except where the context otherwise requires, the definitions given in this chapter govern the construction of this part." Thus, although section 23037 defined "taxpayer" as: "any person or bank subject to the tax imposed under . . . this part," the Board is free to interpret the term as required by the context of the statute.[13] The reasoning in *Finnigan*, which relies on FTB regulations and the purposes of UDITPA provisions, supports the court's and the SBE's construction of "taxpayer" in this context as referring to the unitary group and refusing to throw back sales when any member of the group is taxable in the destination state. The trial court correctly determined that the provisions of UDITPA do not require the state to confine its focus to members of the group that have a jurisdictional nexus to the state when dealing with a hydra-headed corporation with multistate and multinational connections.

There is No Conflict with *Current, Inc.*

Citicorp contends that by "ignoring" the nontaxable status of Citibank (South Dakota), the trial court's decision is contrary to the holding in *Current, Inc. v. State Bd.*

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part *as though the combined entire net income was that of one person,* or to distribute, apportion, or allocate the gross income or deductions between or among such persons, if it determines that such consolidation, distribution, apportionment, or allocation is necessary in order to reflect the proper income of any such persons."

[13] A 1997 amendment to the statute deleted the words "or bank," a change which has no impact on the issues raised herein.

of Equalization, supra, 24 Cal.App.4th 382. *Current, Inc.* has no application here. That decision invalidated a statute that purported to impose a use tax on an out-of-state mail order company based solely on its acquisition by a corporation with substantial California contacts. The *Current, Inc.* case did not involve integrated business operations. The court expressly noted that the parties in that case had stipulated that the two companies " 'did not have integrated operations or management.' " (*Id.* at p. 391.)

Citibank (South Dakota) is not being subjected to a tax in this case. The relevant stipulated fact in this case is that Citicorp and its affiliates, including Citibank (South Dakota) "were conducting a worldwide unitary business during the years in issue, and their combined franchise tax liability must be computed on a unitary basis." The rule applied here results in recognition that the unitary group benefited from sales in California. The decision of the trial court in this case is not contrary to the discussion in *Current, Inc.,* which involved a situation wholly different from an attempt to fairly apportion components of an accepted formula.

Principles of Uniformity Do Not Require Unanimous Acceptance

Citicorp maintains that the *Finnigan* rule violates UDITPA principles of uniformity because the Multistate Tax Commission has not followed it.[14] Citicorp also notes

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[14] The Multistate Tax Commission was created by the Multistate Tax Compact, which was adopted by California in 1974. (§§ 38001, 38006, art. VI.) The Commission is granted,

that two state courts that have considered the *Finnigan* rule have rejected it. (*Dover Corp. v. Department of Revenue* (Ill.Ct.App. 1995) 648 N.E.2d 1089; *Great No. Nekoosa v. State Tax* (Me. 1996) 675 A.2d 963.)[15] Citicorp argues that of 23 states that have adopted UDITPA, only three other states (Utah, Indiana and Kansas) follow the *Finnigan* approach by administrative action. (See 62 West's Ann. Rev. & Tax. Code, § 25128 (2000 pocket pt.), table of jurisdictions, pp. 294-295 [24 states have adopted the uniform act].)

No doubt, the circumstances identified by Citicorp contributed to the SBE's subsequent decision to return to the *Joyce* rule. (*Appeal of Huffy Corporation, supra,* Cal.Tax Rptr. (CCH) ¶ 403-031.) However, the mere fact that other bodies and jurisdictions did not follow the *Finnigan* rule is not a valid basis for this court to disregard the considered decision of a constitutionally created quasi-judicial administrative agency. (Cal. Const., art. XIII, § 17.) Adherence to an outmoded rule for the sake of consistency in the face of compelling reasons to change is not a virtue. Valid principled reasons support the rationale of *Joyce* and the rationale of *Finnigan*. In the absence of legislative direction to the contrary, the SBE is empowered to interpret cases before it in a manner that is consistent with the purposes of the state's tax code.

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among other powers, the power to study state and local tax systems, to make proposals to increase uniformity and simplification, to adopt uniform regulations and, upon request, to perform audits. (§ 38006, art. VI.)

[15] We note that in both of the cited cases, the arguments of the taxpayers were rejected and the taxing authority's interpretation was upheld.

The Legislature has delegated to the SBE the duty of hearing and determining appeals from actions of the FTB. (§§ 19045-19048.) Although the courts "bear ultimate responsibility for construing the statute, we accord great respect to the Board's interpretation." (*City of Gilroy v. State Bd. of Equalization* (1989) 212 Cal.App.3d 589, 597.) Merely pointing to the fact that the Board's decision in *Finnigan* ultimately proved to be a minority position does not support Citicorp's challenge to the legality or constitutionality of the *Finnigan* interpretation of the relevant statute.

The Decision in *Yamaha Corp.* Does Not Require Reversal

Citicorp urges this court to completely disregard the SBE decision in *Finnigan* based on the Supreme Court's analysis of the weight to be given to the SBE's interpretations of law in *Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1. In *Yamaha Corp.*, the Supreme Court distinguished the standard of review of the exercise of an agency's quasi-legislative rulemaking function and agency interpretations of the meaning of a statute. A less deferential standard applies to the latter pronouncements. (*Id.* at pp. 6, 11.) Even so, " . . . 'the judiciary, although taking ultimate responsibility for the construction of the statute, accords great weight and respect to the administrative construction. [Citation.]' " (*Id.* at p. 12.)

The *Yamaha* court determined that the weight to be given to an agency's construction of a statute is "situational" and depends on consideration of two categories of relevant factors. (19 Cal.4th at p. 12.) The court referred to

factors " 'indicating that the agency has a comparative interpretive advantage over the courts' and those 'indicating that the interpretation in question is probably correct.' [Citation.]" (*Ibid.*) Focusing solely on the second category, Citicorp argues that the SBE's *Finnigan* decision was incorrect and should, therefore, be rejected by this court.

As noted above, the Legislature has allocated to the SBE the power to hear and determine appeals of franchise tax matters. (§§ 19045-19047.) The agency's expertise in tax matters is not subject to dispute and Citicorp does not disparage it. Citicorp concentrates its argument on factors indicating the decision was incorrect. The main point relied upon is that the FTB took a litigation position against the *Finnigan* result in that appeal. In considering the impact of an agency's theory in litigating a case, the court in *Culligan Water Conditioning v. State Bd. of Equalization* (1976) 17 Cal.3d 86, noted that little weight would be attached to an argument that was merely a litigating position in a particular matter. (*Culligan, supra,* at p. 93, noted with approval in *Yamaha Corp. of America v. State Bd. of Equalization, supra,* 19 Cal.4th at p. 9.)

We give even less weight than usual to the FTB's litigation position in *Finnigan,* because the agency was merely fulfilling its duty to enforce the previous SBE rule of *Joyce.* Arguments in litigation, although they may be enlightening or helpful, do not control our review of the subsequent acts of the agency.

Citicorp highlights the factors for weighing an agency decision listed in the *Yamaha* opinion. Those factors include: " . . . 'the thoroughness evident in [the

agency's] consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.' [Citation.]" (*Yamaha Corp. of America v. State Bd. of Equalization, supra,* 19 Cal.4th at pp. 14-15.) Citicorp adds two other factors noted by the court: indications of careful consideration by senior agency officials and evidence the agency has consistently maintained the interpretation in question. (*Id.* at p. 13.) Citicorp argues that because the agency has now abandoned *Finnigan* it was poorly reasoned, inconsistently applied and should be given no weight.

The fact that an agency changes its interpretation of a statute is not evidence that either interpretation was legally impermissible. (*Henning v. Industrial Welfare Com.* (1988) 46 Cal.3d 1262, 1269-1270.) " 'In the general case, of course, an administrative agency may change its interpretation of a statute, rejecting an old construction and adopting a new. [Citations.] Put simply, "[a]n administrative agency is not disqualified from changing its mind. . . . " [Citation.]' " (*Californians for Political Reform Foundation v. Fair Political Practices Com.* (1998) 61 Cal.App.4th 472, 488.) As long as the change is constitutionally and legislatively permissible, an agency would be remiss in not adapting its interpretation of the rules to fit the practicalities and present economic conditions dictating a change.

The SBE and FTB followed *Finnigan,* decided in August of 1988, until the April, 1999 decision in *Huffy.* It represented the SBE's decision in litigation between the FTB and a taxpayer, and was supported by convincing reasoning. Finnigan Corporation's California subsidiary

made sales into states where Finnigan itself was taxable, but the subsidiary was not. The SBE accepted Finnigan Corporation's argument that the FTB was interpreting the word "taxpayer," for purposes of the throwback rule, in a different way than it did all other provisions of the UDITPA. The SBE acknowledged the definition of "taxpayer" in section 23037 referred to "any person" but relied on section 23030, which allowed it to vary that definition "where the context otherwise requires." The SBE reviewed FTB regulations under UDITPA and noted that the word "taxpayer" was used in at least two senses, with the most prevalent meaning being the combined unitary group. The SBE concluded that this interpretation was consistent with the unitary theory of apportioning California sales among the members of the group.

We find no legal error in the *Finnigan* approach. (*Barclays Bank Internat., Ltd. v. Franchise Tax Bd.* (1992) 2 Cal.4th 708, [constitution does not mandate use of any particular method of apportionment so long as method used is not arbitrary].) One decision from Maine referenced *Finnigan* and recognized that authority on this issue was divided. That court chose the opposite interpretation under that state's law. (*Great No. Nekoosa v. State Tax, supra,* 675 A.2d at pp. 965-966.)[16] The SBE decision in *Finnigan* was supported by reference to the relevant statutes and regulations, and a reasoned analysis of the issues. Furthermore, the SBE reconsidered and affirmed

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[16] The other case cited by Citicorp did not discuss *Finnigan,* but determined that the term "taxpayer" did not refer to the unitary group, but to the individual seller. (*Dover Corp. v. Department of Revenue, supra,* 648 N.E.2d 1089.)

its decision in *Finnigan II* and *NutraSweet*. Even in *Huffy*, where the SBE eventually determined it should abandon the *Finnigan* rule, the SBE did not conclude that *Finnigan* was legally deficient. In *Finnigan II* the SBE noted scholarly criticism of *Joyce*, and determined that changes in the interpretation of federal law since *Joyce* led to the decision in *Finnigan*. At that time, the SBE believed that the *Finnigan* rule, if accepted by other states, would be the fairer method and would promote uniformity among the jurisdictions. (*Appeal of Finnigan Corporation*, opn. on petn. for rehg., *supra*, Cal.Tax Rptr. (CCH) ¶ 401-797 [*Finnigan II*].)

Justice Holmes often said that the life of the law is experience. By the time of the *Huffy* decision, the SBE had approximately nine years of experience since *Finnigan II* in which to evaluate the operation of that rule. The SBE noted that, contrary to its expectation, *Finnigan* had not been met with universal acceptance. The Board recognized that *Finnigan* remained a minority rule, which was contrary to the goal of uniformity and in fact, allowed the possibility of exposure to double taxation. (*Appeal of Huffy Corporation, supra*, Cal.Tax Rptr. (CCH) ¶ 403-031.) The Board correctly stated that there were "theoretically good reasons for the initial implementation of the *Finnigan/NutraSweet* rule," but that the actual implementation did not result in the expected uniformity. Thus, after reviewing the state of the law in the years intervening between its decisions, the SBE returned to the *Joyce* rule without finding legal flaws in the *Finnigan* rule.[17] *Finnigan* simply did not withstand the test of time.

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[17] The original decision in *Huffy* contained a footnote to the effect that California was "improperly" taxing some income

We find the SBE's decisions to be thorough and reasoned. The SBE launched the *Finnigan* rule in the expectation that it would be widely accepted. It adhered to the rule for over nine years, subsequently reevaluated its position in light of relevant intervening legal developments and changed its mind. All decisions were arrived at in an adversary forum, which presumes the existence of vigorous advocacy and careful consideration by a quasi-judicial decision-maker. There is no reason to reject the application of *Finnigan* merely because the SBE has recognized that the passage of time did not result in its expected acceptance by other states.

Application of *Finnigan* to Citicorp's Return

Citicorp argues that we must order the FTB either to apply *Huffy* retroactively or prevent it from applying *Finnigan* retroactively to assure treatment under the rule of *Joyce* for Citicorp's taxes.[18] *Finnigan* and *NutraSweet* did not discuss the retroactivity of the decision, but it is

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under the *Finnigan* rule. This footnote was deleted in the opinion on rehearing in that case. (*Appeal of Huffy Corporation* (opn. on petn. for rehg. Sept. 1, 1999) Cal.Tax Rptr. (CCH) ¶ 403-052.)

[18] We note that although a taxpayer may appeal a decision of the SBE, there is no statutory authorization for the FTB to appeal. The result in *Finnigan* favored the taxpayer, so no appeal was taken. (§ 19048 [FTB or taxpayer may petition for rehearing of SBE decision]; § 19382 [taxpayer may bring an action after denial of claim for refund].)

undisputed that the FTB, pursuant to Notice No. 90-3, has applied *Finnigan* retroactively.[19]

According to exhibits produced in the trial court, Citicorp's amended returns, although pertaining to the years 1985 through 1988, were filed in 1992 and 1993, after both *Finnigan* opinions and the FTB Notice No. 90-3. "As the Board notes, a refund case throws open the taxpayer's entire tax liability for the period in question [citation], and the Board may raise issues unrelated to the basis or theory on which the taxpayer is seeking a refund in order to defeat the claim. [Citation.]" (*Title Ins. Co. v. State Bd. of Equalization* (1992) 4 Cal.4th 715, 732.) Thus, the SBE may raise items regarding the taxpayer's return "for the timeframe encompassed in the refund claim period which might be set off against [the taxpayer's] refund claim. . . . " (*Sprint Communications Co. v. State Bd. of Equalization* (1995) 40 Cal.App.4th 1254, 1260.) The FTB simply applied the law in effect during the time period in which Citicorp filed the amended returns in accordance with policy and procedures applicable to all reviews.

In general, tax legislation is not retroactive. (§ 23058.) However, section 19503, which states that the Franchise Tax Board "shall prescribe all rules and regulations necessary for the enforcement of . . . [the Bank and Corporation Tax Law, section 23001 et seq.]" also provides that the

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[19] *Huffy* expressly discussed the retroactivity issue and determined that because taxpayers had relied on *Finnigan*, it would be fair to apply the *Huffy* return to the rule of *Joyce* prospectively to income years beginning on or after September 1, 1999. (*Appeal of Huffy Corporation*, opn. on petn. for rehg., *supra*, Cal.Tax Rptr. (CCH) ¶ 403-052.)

Franchise Tax Board "may prescribe the extent to which any ruling [or regulation] shall be applied without retroactive effect." Although Notice No. 90-3 is not a formal regulation, it represents an exercise of the FTB's authority to prescribe rules and determine the effect of such rules. At the time Citicorp filed its amended returns seeking a refund, the FTB's position on the application of *Finnigan* was clear.

Unlike legislation, the general rule as to judicial opinions is that they are fully retroactive. The United States Supreme Court stated that in general, civil decisions "must be given full retroactive effect in all cases still open on direct review and as to all events, regardless of whether such events predate or postdate the announcement of the rule." (*Harper v. Virginia Dept. of Taxation* (1993) 509 U.S. 86; *Newman v. Emerson Radio Corp.* (1989) 48 Cal.3d 973, 978-982, [noting the "general rule that judicial decisions are given retroactive effect"].) Retroactive application of *Finnigan* was an exercise of the prevailing rule regarding changes in the law.

We reject Citicorp's request that we order retroactive application of *Huffy* so that it may benefit from the change that occurred after the trial court's judgment in this case. We find no basis for overturning the SBE's well-reasoned decision on the issue of prospective application of *Huffy*. The SBE relied in its analysis on the factors in *Chevron Oil Co. v. Huson* (1971) 404 U.S. 97, in reaching the decision that *Huffy* should be applied only prospectively. Although *Harper* cast doubt on the three-part test set out in *Chevron Oil*, *Harper* involved federal law, and noted that state courts had a degree of freedom to "limit the retroactive operation of their own interpretations of

state law. . . . " (*Harper v. Virginia Dept. of Taxation, supra,* 509 U.S. at p. 100.) The *Chevron Oil* factors, as discussed in *Huffy,* support the decision in that case. In *Chevron Oil* the court identified three factors to be considered when dealing with the issue of nonretroactivity. "First, the decision to be applied nonretroactively must establish a new principle of law, either by overruling clear past precedent on which litigants may have relied, [citation] or by deciding an issue of first impression whose resolution was not clearly foreshadowed, [citation]." The second factor considers whether in light of the "history . . . purpose and effect" of the rule in question its operation will be furthered or retarded by retrospective application. The third factor weighs "the inequity imposed by retroactive application" and whether it would produce " . . . substantial inequitable results . . . ' "injustice or hardship" '. . . . [Citation.]" (*Chevron Oil Co. v. Huson, supra,* 404 U.S. at pp. 106-107.)

The SBE decision in *Huffy* clearly established a new principle of law and overruled past precedent on which taxpayers relied. The history, purpose and effect of the rule indicate an agency attempt to lead a movement to nationwide uniformity that ultimately failed. However, the *Finnigan* rule was adhered to and relied upon for tax planning purposes for the years between *Finnigan* and *Huffy.* Although denying retroactive effect to *Huffy* results in a decreased refund for Citicorp, it is not clear that all taxpayers would benefit from retroactive application. The rule in *Finnigan* itself was advocated by the taxpayer. An undesirable result for one taxpayer is not a basis for rejecting a reasoned decision of the SBE that examined the broad negative effects of retroactivity.

The SBE merely followed the normal rule of full retroactive application when it decided *Finnigan*. The fact that it made an exception in *Huffy* does not require a special rule for Citicorp. We decline the invitation to adjust the agency's reasoned resolution of the application of its own rules.[20]

Finnigan Does Not Violate Constitutional Standards

Citicorp argues that the *Finnigan* rule violates the commerce clause, the due process clause and the equal protection clause of the United States Constitution. In discussing an attack on the California three-factor formula for apportionment of the income of a unitary business located in California, the United States Supreme Court noted that the California formula not only met the court's approval, but "has become . . . something of a benchmark against which other apportionment formulas are judged." (*Container Corp. v. Franchise Tax Bd., supra,* 463 U.S. at p. 170.) In its discussion of a commerce clause and due process challenge to the three-factor formula, the Supreme Court stated the standard that the formula must meet to avoid violation of those constitutional provisions. The first test is one of "internal consistency" which means that "the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business' income being taxed." (*Id.* at p. 169.)

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[20] We also decline the suggestion that *Huffy* should be selectively applied to Citicorp. (*Waller v. Truck Ins. Exchange, Inc.* (1995) 11 Cal.4th 1, 25 [noting United States Supreme Court's rejection of argument that court should consider equities of each case in deciding issue of retroactivity].)

Citicorp does not argue that the *Finnigan* rule violates the principle of internal consistency.

The only evidence supporting Citicorp's argument was the testimony of its tax counsel. Jeffrey Serether, Vice President and state and local tax counsel for Citicorp and its subsidiaries, testified that he reviewed, but had not prepared, the tax returns filed by the South Dakota affiliate for the four years at issue. He stated that Citibank (South Dakota) "reports a franchise tax for financial institutions" to South Dakota, which it calculates based on a three-factor apportionment formula. (S.D. Code Laws § 10-43-22.1.)[21] In the four years in question, Citibank (South Dakota) apportioned 100 percent of its income to South Dakota. There was no further detail regarding South Dakota taxes or filings by Citicorp affiliates.

Citicorp's argument implicates the second factor in the Supreme Court's analysis, that of "external consistency," which means that "the factor or factors used in

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[21] South Dakota has adopted the UDITPA. (62 West's Ann. Rev. & Tax Code, § 25120 (2000 pocket pt.) p. 295, "Table of Jurisdictions Wherein Act Has Been Adopted.") The South Dakota statute provides that financial institutions "engaged in business within and without the state shall be taxed only on such business as is properly apportioned to this state. All net income shall be apportioned to this state by multiplying the net income by a fraction, the numerator of which is the property factor, plus the payroll factor plus the receipts factor, the denominator of which is three." (S.D. Code Laws § 10-43-22.1.) The receipts factor "is a fraction, the numerator of which is the total receipts of the financial institution in the state during the tax period, and the denominator of which is the total receipts of the financial institution in all the states. . . . " (S.D. Code Laws § 10-43-25.1.)

the apportionment formula must actually reflect a reasonable sense of how income is generated." (*Container Corp. v. Franchise Tax Bd., supra,* 463 U.S. at p. 169.) "[T]he taxpayer's burden of proof on [the issue of showing a violation of the 'external consistency' test] is 'steep if not insurmountable.' [Citation.]" (*Colgate-Palmolive Co. v. Franchise Tax Bd.* (1992) 10 Cal.App.4th 1768, 1785.)[22] There was no evidence indicating that application of *Finnigan* distorted the percentage of income fairly allocable to California. Rather, the evidence reflected the reasonable apportionment of sales generated in California.

Citicorp's constitutional challenges are also based on its contention that *Finnigan* results in exposure to multiple taxation of the income of the out-of-state affiliate. Exposure to duplicative taxation resulting from a lack of uniformity among the states does not present a constitutional issue. The Supreme Court has acknowledged the fact that companies doing business in more than one state may be exposed to different taxing rules. The court recognized the differences that exist between the various states in how taxes are calculated. "[W]hile some [s]tates such as Iowa assign sales by destination, 'sales can be assigned to the state . . . of origin, the state in which the sales office is located, the state where an employee of the business making the sale carries on his activities or where the order is first accepted, or the state in which an interstate

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[22] On certiorari to the United States Supreme Court, the *Colgate-Palmolive* case was consolidated with *Barclays Bank PLC v. Franchise Tax Bd. of Cal.* (1994) 512 U.S. 298. The Supreme Court upheld California's method of determining income, rejecting plaintiff's claim that the method impaired federal uniformity in international trade.

shipment is made.' [Citation.]" (*Moorman Mfg. Co. v. Bair* (1978) 437 U.S. 267, 278, fn. 13.) Prevention of such possibilities of duplicate taxation would require adoption of a national uniform code, a task the court found better suited to an exercise of the legislative, than the judicial power. (*Id.* at pp. 279-280.) Plainly, the Constitution does not mandate that every state treat every item of income alike and assign the apportionment of sales in a uniform manner.

The Supreme Court has stated that the Constitution does not " 'invalidat[e] an apportionment formula whenever it may result in taxation of some income that did not have its source in the taxing [s]tate. . . . ' [Citation.]" (Italics omitted.) (*Container Corp. v. Franchise Tax Bd., supra,* 463 U.S. at pp. 169-170.) An apportionment formula will only be struck down where the challenger proves " 'by "clear and cogent evidence" that the income attributed to the State is in fact "out of all appropriate proportions to the business transacted . . . in that State," [citation] or has "led to a grossly distorted result," [citation].' " (*Id.* at p. 170.) Citicorp has not sustained this burden.

Although constitutional limits on a state's ability to tax interstate businesses exist, they allow the states "wide latitude" to choose a method of apportionment. (*Moorman Mfg. Co. v. Bair, supra,* 437 U.S. at p. 274.) The main restrictions on a state's ability to tax are: (1) a minimal connection between the activities of the business and the taxing state; and (2) the "income attributed to the [s]tate for tax purposes must be rationally related to 'values connected with the taxing [s]tate.' [Citation.]" (*Id.* at pp. 272-273.) Thus, when a state's method of apportionment

represents "a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing [s]tate," no constitution violation exists. (*Id.* at p. 273.) Where the state's method appears to reach only the profits earned in the state, and the taxpayer failed to show that " 'the method of apportionment . . . was inherently arbitrary, or that its application . . . produced an unreasonable result' " the state's action is within constitutional bounds. (*Id.* at pp. 274.)

There is nothing arbitrary or unconstitutional about assigning Citibank's (South Dakota) credit card sales and transactions actually occurring in California to California. Such an assignment reasonably recognizes the contribution of the state in producing the income of the unitary group. Citicorp has not shown the allocation to California is " 'out of all appropriate proportions to the business transacted . . . in that State. . . . ' " (*Container Corp. v. Franchise Tax Bd., supra,* 463 U.S. at p. 170.)

Gain From the Sale of Buildings Properly Classified As Business Income

Citicorp reported gains on the sale of real property in New York and Japan as nonbusiness income, allocated to the situs of the property. The FTB determined that the sales were business income, subject to apportionment by means of the apportionment formula. (*Robert Half Internat., Inc. v. Franchise Tax Bd.* (1998) 66 Cal.App.4th 1020, 1023.) The main thrust of Citicorp's claim that the gains are nonbusiness income is that these sales of corporate property were not made in the regular course of its business of banking. The parties disagree as to whether

the transactional test or the functional test is used to determine the nature of nonbusiness income. We note that the issue is presently pending before our Supreme Court. (*Hoechst Celanese Corp. v. Franchise Tax Bd.*, review granted Mar. 1, 2000, S085091.) The resolution of the issue of whether there are two tests is unnecessary in this case, because the questioned gain on sales produced business income under either the transactional or functional test.

The nonbusiness income of a unitary business is not apportionable and is allocated according to situs. (§§ 25123-25127.) Nonbusiness income is defined as "all income other than business income." (§ 25120, subd. (d).) The definition of business income is: "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." (§ 25120, subd. (a).)

The "transactional" test of business income is represented by the first part of the statutory definition, regarding income arising from transactions "in the regular course" of business. The "functional" test is derived from the second part of the definition, regarding property acquired, managed and disposed of as "integral parts" of the regular business. (*Robert Half Internat., Inc. v. Franchise Tax Bd., supra,* 66 Cal.App.4th at p. 1024.)[23] In addition,

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[23] In the *Robert Half* case, the parties agreed that there were two tests of nonbusiness income and that the loss at issue would not qualify under the transactional test, so the court was not faced with resolution of those issues. (66 Cal.App.4th at p. 1024.)

the administrative regulations provide that "income of the taxpayer is business income unless clearly classifiable as nonbusiness income." (Cal. Code Regs., tit. 18, § 25120, subd. (a).)

Citicorp argues that there is only a single transactional test of business income and that its sale of corporate realty did not occur in the regular course of its banking business. It also argues that even if there is a separate functional test, the acquisition, management and sale of the properties was not an integral part of its business. Proper characterization of the nature of the income is primarily a factual issue. (*Robert Half Internat., Inc. v. Franchise Tax Bd., supra,* 66 Cal.App.4th at p. 1028.) We review the facts relating to the purchase, use and sale of each of the four properties.

In 1961, Citibank, N.A., financed and constructed a 39-story office building at 399 Park Avenue in New York City, for the purpose of housing corporate personnel.[24] During the years in issue, it was the corporate headquarters of Citicorp and Citibank. In 1987, Citibank sold floors 17 through 39 of the building as part of a planned restructuring of its real estate holdings. At the time of the sale, personnel of Citicorp affiliates occupied all of the floors,

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[24] The stipulated facts disclose that Citicorp owns 100 percent of Citibank, N.A., which is a "full-service commercial bank that offers a broad range of banking and financial services throughout the world, such as traditional lending, deposit taking, and investment management activities." Citicorp itself is "part of a worldwide financial services organization which serves the financial needs of individuals, businesses, governments and financial institutions throughout the United States and in many other countries."

and continued to occupy the floors remaining after the sale. Corporate Realty Services, a department of Citibank that manages premises occupied by Citicorp and its affiliates, managed the building.

In 1907, Citibank purchased a nine-story office building at 55 Wall Street in New York City for the purpose of housing corporate personnel. Citibank financed the acquisition of this building. Personnel of Citibank and affiliate companies occupied three of the nine floors at the time of the 1987 sale of the building. Corporate Realty Services managed the building.

The third building was a 59-story office building in New York City known as Citicorp Center. Citibank financed and constructed the building in 1978 for the purpose of housing Citicorp and Citibank personnel. In 1987, it sold floors 23 through 59 as a part of the restructuring of its real estate holdings. Citibank and its affiliates occupied 28 floors, or approximately 47 percent of the building at the time of sale and 24 percent of the floors sold. From 1978 until the early 1980's Corporate Realty Services managed the building. In the early 1980's, Citibank hired an outside agent to manage the building. Portions of the buildings were leased to third parties, including accounting firms and attorneys who did business with the bank. Citicorp characterized all dealings with third parties as "arm's length."

Citibank purchased the fourth property in 1954, consisting of a residential building and undeveloped land in Osaka Japan. Citibank financed the purchase and Corporate Realty Services was responsible for managing this property. Corporate personnel used this property when

they were in Japan. In 1987, a Japanese branch of Citibank sold the building and land, known as ISU House and the Osaka land. Corporate Realty Services managed the building during the relevant years.

Additional facts contained in the exhibits produced in the trial court include the fact that Citibank financed the purchase of all of the properties. Corporate Realty Services, in addition to managing the buildings, also had responsibility for leasing office space in the buildings. As noted previously, prior to the sale, Citicorp included costs and income from the properties as business income, reporting the value of the four properties as business property and the income from rentals as business income. The following facts were stipulated to regarding tax treatment of cost of and income from the buildings. "During the income years in issue and prior to the sale of each building, or part thereof, [appellant] included the original cost of the office buildings located at 399 Park Avenue, 55 Wall Street, Citicorp Center and the ISU House and Osaka land in the denominator of the property factors used to determine the portion of [appellants'] business income attributable to California sources. During the income years in issue and prior to the sales of each building, or part thereof, [appellant] also included any rental income and expenses associated with the management of each building in determining [appellants'] business income attributable to California sources."

According to the terms of the transactional test, Citicorp urges that we must look to the nature of the transaction to determine whether it occurred in the regular course of a taxpayer's business. The stipulated facts state

that the sales of the properties were parts of a restructuring of Citicorp's real estate holdings. There is no evidence as to how often, or for what purpose Citicorp was restructuring its real estate holdings other than the fact that the restructuring resulted in sales of four corporate properties in one year. There is no evidence regarding the extent of its real estate holdings. This is not the same situation as the example of a manufacturer that makes a one-time sale of a warehouse. (See, e.g., Keesling & Warren, *California's Uniform Division of Income for Tax Purpose Act* (1967) 15 UCLA L.Rev. 156, 164 (hereafter Keesling).) Citicorp presented no evidence of the frequency, nature or extent of the real estate management activities of Corporate Realty Services. Citicorp argues that the sole function of its real estate management department was to manage property occupied by Citicorp affiliates. However, it references no evidence in the record as to the operations or function of the real estate department, other than the few stipulated facts in the record. The evidence was only that Citibank has a department devoted to management and leasing of real property. The evidence also supports a finding that Citicorp considered the income from the real estate properties to be business income prior to the sale. We conclude from the record in this case that Citicorp, with its separate department that acquires, manages, leases and ultimately sells corporate real property, produces business income when it engages in these transactions.

The Citicorp corporate properties, financed by Citibank, occupied to a substantial extent by its personnel, and managed by the realty services department of its

wholly-owned subsidiary, are integral parts of its business under the functional test. As noted by the trial court, the buildings were constructed or acquired to serve as important locations for Citicorp's operations. Citibank or its real estate department, acquired, constructed, financed, managed, leased, and eventually sold all of the properties after using them for significant operating purposes.

We note that the functional test is not concerned with the frequency or extraordinary nature of a sale. Under that test, the gain is business income if the asset disposed of was used by the taxpayer in its regular trade or business operations. The functional test predates adoption of the UDITPA, and tracks the California definition of unitary income. (*Appeal of Borden, Inc.* (Feb. 3, 1977) [1971-1978 Transfer Binder] Cal.Tax Rptr. (CCH) ¶ 205-616; Keesling, *supra,* 15 UCLA L.Rev. at p. 164.) As illustrated by the commentators, "the sale by a shoe manufacturer of one of its factories is hardly a transaction 'in the regular course of the taxpayer's trade or business' (which is selling shoes, not selling factories), but perhaps the 'acquisition, management and disposition' of the factory was an integral part of the business of making and selling shoes." (Keesling, *supra,* 15 UCLA L.Rev. at p. 164.)

There can be little argument that Citicorp managed its corporate headquarters, other office buildings, and the property in Japan as an integral part of its business. Although Citicorp repeatedly refers to itself as a bank, the stipulated facts indicate that Citibank is a bank, while Citicorp is a "worldwide financial services organization

which serves the financial needs of individuals, businesses, governments and financial institutions throughout the United States and in many other countries."

Citicorp lists several cases from other jurisdictions which it argues are well reasoned, were ignored by the trial court, and provide support for its conclusion that a banking company that sells its corporate office can never be assessed for business income on the gain.[25] As noted in the case of *Polaroid Corp. v. Offerman* (N.C. 1998) 507 S.E.2d 284, 289, those cases held that only a transactional

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[25] Citicorp argues that the trial court incorrectly found that FTB regulations did not compel business income treatment of the gains. FTB Regulation 25137-4-1. (Cal. Code Regs., tit. 18, § 25137-4-1.) The referenced regulation states that "[a]ll income of banks and financial corporations shall be 'business income' unless the income arises from an investment or activity which is not a banking function." However, the evidence supported a factual determination that these gains arose as a part of the normal business activity of Citicorp group's unitary business operations. Citicorp offered no evidence that maintaining space for personnel was not a part of its banking functions. The second regulation Citicorp argues would require business income treatment is FTB Regulation 25120, subd. (c)(2), which is one of several illustrative examples of what constitute business income. (Cal. Code Regs., tit. 18, § 25120, subd. (c)(2).) Citicorp argues that it should get special treatment for the floors of the buildings it did not occupy. The examples do not help Citicorp. One states that a manufacturing plant that is continuously used in the business and subsequently sold generates business income. One of them posits a taxpayer's manufacturing plant that is closed, put up for sale, and rented out while being held for sale. The rental income and the gain on the sale were business income. (Cal. Code Regs., tit. 18, § 25120, subd. (c)(2), exs. B-D.) The examples in the regulation do not require reversal of the judgment.

test exists under UDITPA, and those state legislatures "promptly amended their respective tax statutes to explicitly include the functional test within their definition of business income." Other states have disagreed with the cases relied upon by Citicorp. (See discussion in *Polaroid, supra,* 507 S.E.2d at pp. 290-293; *Texaco-Cities Service Pipeline v. McGaw* (Ill. 1998) 695 N.E.2d 481, *Nat. Realty & Inv. Co. v. Ill. Dept. of Rev.* (Ill.Ct.App. 1986) 494 N.E.2d 924, 932 [under the functional test, all gain from the disposition of a capital asset is business income if the asset disposed of was "used by the taxpayer in its regular trade or business operations"]; *Ross-Araco v. Com., Bd. of Fin. & Rev.* (Pa. 1996) 674 A.2d 691 [if asset produced business income while it was owned by the taxpayer, gain on sale is business income].) Regardless, the record in this case establishes that the income from the sale of the properties derived from corporate activities satisfying either test in California.

Consideration of Gains on Sale of Office Buildings Is Constitutional

In two short paragraphs, citing *Allied-Signal, Inc. v. Director, Div. of Taxation* (1992) 504 U.S. 768, 787-789 and *ASARCO Inc. v. Idaho State Tax Comm'n* (1982) 458 U.S. 307, Citicorp asserts that the inclusion of gains from the sale of the buildings in the apportionment formula is unconstitutional. It contends that because Citicorp personnel did not occupy all portions of the buildings, the proceeds of the sale could not have been operational, but must have been for investment purposes. Citicorp did not produce any evidence on this point other than the percentage of occupancy by Citicorp personnel. The fact

remains that its property management division rented out portions of the buildings and that Citicorp claimed the rental income as business income. It does not appear that Citicorp attempted to separate out the various portions of the buildings when it initially reported them as business income prior to the sales.

Allied-Signal did not involve the sale of corporate real estate, but concerned a gain realized on the sale of a corporate taxpayer's shares of stock, originally purchased in the open market, in an unrelated New Jersey company. (*Id.* at pp. 774-775.) The court considered the question of whether, by including the gain on the sale of stock as having been earned in the unitary business, New Jersey violated constitutional limitations on taxing value earned outside its borders. The court concluded that the activity at issue had no connection with the State of New Jersey and was completely unrelated to the unitary business. The court held that such capital transactions must "serve an operational rather than an investment function." (*Id.* at p. 787.) The court explained: "It remains the case that '[i]n order to exclude certain income from the apportionment formula, the company must prove that "the income was earned in the course of activities unrelated to [those carried out in the taxing] State." ' " (*Id.* at p. 787.)

Similarly, *ASARCO Inc. v. Idaho State Tax Comm'n, supra,* 458 U.S. 307, concerned gains from the sale of stock and dividends from subsidiaries which had no unitary business relationship with the taxpayer. The court merely accepted the proposition that if assets are part of the unitary business, the income from those assets may be treated like any other business income. It refused to allow consideration for tax purposes of dividend income

"[w]here the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing [s]tate. . . . " (*Id.* at p. 327.)

The principles discussed in the cited cases impose no limits on the disposition of a corporate headquarters and other corporate properties by a wholly owned subsidiary of the unitary business. " 'The general rule, applicable here, is that a taxpayer claiming immunity from a tax has the burden of establishing his exemption. This burden is never met merely by showing a fair difference of opinion which as an original matter might be decided differently. . . . Of course, in constitutional cases, we have power to examine the whole record to arrive at an independent judgment as to whether constitutional rights have been invaded, but that does not mean that we will re-examine, as a court of first instance, findings of fact supported by substantial evidence.' [Citation.]" (*Container Corp. v. Franchise Tax Bd., supra,* 463 U.S. at pp. 175-176.)

The corporate office buildings in this case were not held as separate assets unrelated to the unitary business. Citicorp has not shown that the occupation and use of its office buildings had no connection to the California aspects of its multistate business. Citicorp included the costs and the income from all of the properties as business income prior to the sale. Inclusion of the gain from disposition of the properties is consistent with the stated constitutional limits on a state's taxing authority. The disposition of the real estate was stipulated to be a part of Citicorp's restructuring of its real estate holdings, a program that was not described further. Based upon the foregoing, the FTB's decision to categorize the capital

gains as business income is reasonable, within constitutional limits, and is supported by the evidence.

CONCLUSION

Because the trial court's findings are supported by substantial evidence and the implementation of the rules was a valid exercise of the interpretive powers of the SBE, the judgment is affirmed.

_____
Marchiano, J.

We concur:

_____
Strankman, P.J.

_____
Stein, J.

CERTIFIED FOR PUBLICATION

Citicorp North America, Inc. v. Franchise Tax Bd., A086925

Trial Court: San Francisco County Superior Court

Trial Judge: The Honorable Ollie Marie-Victoire, Judge

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Citicorp North America, Inc. & Affiliates v. Franchise Tax Board, A086925

APPENDIX B

CERTIFIED FOR PUBLICATION

IN THE COURT OF APPEAL
OF THE STATE OF CALIFORNIA
FIRST APPELLATE DISTRICT
DIVISION ONE

CITICORP NORTH AMERICA, INC. & AFFILIATES, Plaintiffs and Appellants, v. FRANCHISE TAX BOARD, Defendant and Respondent.	A086925 (San Francisco County Super. Ct. No. 990474) **ORDER MODIFYING OPINION; and DENYING REHEARING [No Change in Judgment]** (Filed Court of Appeal – First App. Dist. Nov. 01 2000)

BY THE COURT:

It is ordered that the opinion filed October 2, 2000, be modified in the following particulars:

1. On pages 29-30, footnote 25 is changed to read as follows:

> Citicorp argues that the trial court incorrectly found that FTB regulations did not compel business income treatment of the gains. (Cal. Code Regs., tit. 18, § 25137-4-1.) The referenced regulation states that "[a]ll income of banks and financial corporations shall be 'business income' unless the income arises from an investment or activity which is not a banking function." However, the evidence supported a factual

determination that these gains arose as a part of the normal business activity of Citicorp group's unitary business operations. Citicorp offered no evidence that maintaining space for personnel was not a part of its banking functions. Citicorp argues that the second referenced regulation would actually require business income treatment. FTB Regulation 25120, subd. (c)(2) contains several illustrative examples of what may differentiate business from nonbusiness income. (Cal. Code Regs., tit. 18, § 25120, subd. (c)(2).) Citicorp argues that it should get special treatment for the floors of the buildings it did not occupy. The examples do not help Citicorp. One states that a manufacturing plant that is continuously used in the business and subsequently sold generates business income. One of them posits a taxpayer's manufacturing plant that is closed, put up for sale, and rented out while being held for sale. The rental income and the gain on the sale were business income. (Cal. Code Regs., tit. 18, § 25120, subd. (c)(2), exs. B-D.) The examples in the regulation do not require reversal of the judgment.

2. On page 31 footnote 26 is inserted following the word "affirmed" in the last sentence of the opinion and reads as follows:

> "Appellant's request for judicial notice is granted. The documents therein and the referenced web site of the Franchise Tax Board were reviewed, but were not useful in the analysis of the issues raised on appeal. The court recognizes that the Franchise Tax Board documents submitted disclose an intent to return to the rule of *Joyce*."

This modification does not effect a change in the judgment.

Appellant's petition for rehearing is denied.

Strankman, P.J.

Trial Court: San Francisco County Superior Court

Trial Judge: The Honorable Ollie Marie-Victoire, Judge

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Citicorp North America, Inc. & Affiliates v. Franchise Tax Board, A086925

APPENDIX C

SUPERIOR COURT OF THE STATE OF CALIFORNIA
CITY AND COUNTY OF SAN FRANCISCO

CITICORP NORTH AMERICA, INC. AND AFFILIATES, Plaintiffs, v. FRANCHISE TAX BOARD, Defendant.	No. 990474 COURT'S AMENDED STATEMENT OF DECISION (Filed March 3, 1999)

The above-entitled matter came on regularly for court trial on October 5, 1998, before the Honorable Ollie Marie-Victoire, judge presiding. Eric J. Coffill, Esq. and Lisa R. Brenner, Esq. appeared on behalf of plaintiffs. Deputy Attorney General David Lew appeared on behalf of defendant. The parties submitted trial briefs at the commencement of trial. A joint stipulation of facts and several joint exhibits were admitted into evidence. Oral testimony from one witness was offered by plaintiffs. After further briefing by the parties, the Court issued a proposed Statement of Decision. Following a hearing on plaintiffs' objections to the proposed Statement of Decision, the Court now makes the following amended Statement of Decision.

SUIT FOR TAX REFUND

This is a corporation franchise tax refund case in which plaintiffs, Citicorp North America, Inc., and affiliates, seek to recover from defendant, Franchise Tax Board ("Board"), a refund of $12,347,622.00, plus applicable interest thereon, for income years ended December 31, 1985 through December 31, 1988 ("years in issue").

FACTS

The facts giving rise to this controversy are undisputed. Plaintiffs are comprised of Citicorp North America, Inc., a Delaware corporation, and approximately 85 affiliated corporations who are the California taxpayer members of a worldwide financial services organization which serves the financial needs of individuals, businesses, governments and financial institutions throughout the United States and in many other countries.

All of the plaintiffs are either directly or indirectly owned by Citicorp, a Delaware corporation. Citicorp is also the sole shareholder of Citibank, N.A., a full-service commercial bank that offers a broad range of banking and financial services throughout the world. Citibank, N.A. and Citicorp are members of plaintiffs' unitary group.

Citibank (South Dakota), N.A., another member of plaintiffs' unitary group, is a national banking association organized under the laws of the United States. An issuer of Visa and MasterCard credit cards, it was not subject to California franchise or income tax, but did have credit card customers in California.

For each of the years in issue, plaintiffs originally filed California franchise tax returns on a separate company basis. Plaintiffs subsequently filed an amended return for each of the years in issue, taking the position that they were conducting a worldwide unitary business and thus determined their California franchise tax liability on a unitary basis. The amended returns, which constituted claims for refund, sought tax refunds in the total amount of $28,219,973, plus interest, for the years in issue.

In calculating the amount of refund sought, plaintiffs took the position in their amended returns that (1) the California sales and property of Citibank (South Dakota), N.A. should not be included in the numerator of the apportionment formula used to determine the portion of plaintiffs' business income attributable to California sources; and (2) all of the gains from the sale of all or a portion of four buildings – three office buildings in New York City and a residence in Osaka, Japan — should be classified as nonbusiness income not taxable in California.

After auditing plaintiffs' amended returns, the Board partially granted plaintiffs' claims for refund in the amount of $16,517,500, but denied plaintiffs' claims in the amount of $11,702,473. In partially denying plaintiffs' claims for refund, the Board accepted plaintiffs' position that they were conducting a unitary business and determined that:

1. The California sales and property of Citibank (South Dakota), N.A. should be included in the numerator of the apportionment formula used to determine the

portion of plaintiffs' business income attributable to California sources;

2. All of the gains from the sale of all or a portion of each of the four above-described buildings should be included in plaintiffs' business income subject to apportionment to California.

The first of the buildings is a 39-story office building located at 399 Park Avenue in New York City. Constructed in 1961, it served as the corporate headquarters of Citicorp/Citibank, N.A. Personnel of Citicorp affiliates occupied all of the 39 floors in the building at the time of its sale. Corporate Realty Services, a department of Citibank, N.A. that manages Citicorp's and its affiliates' occupied premises, was responsible for managing the building at the time of sale. In 1987, 23 of the 39 floors were sold for a gain.

The second building is a nine-story office building, purchased in 1907, and located at 55 Wall Street in New York City. Three floors were occupied by personnel of Citibank, N.A. and/or its affiliates at the time of sale. The other floors of the building were managed by Citibank, N.A.'s Corporate Realty Services. Citibank, N.A. sold the building in 1987.

The third building is a 59-story office building known as the Citicorp Center, which was constructed in 1978 in New York City. In 1987, Citibank, N.A. sold floors 23 through 59 of the building. Citibank, N.A. and/or its affiliates occupied 28 floors at the time of sale. Citibank, N.A.'s Corporate Realty Services managed the floors [sic] the building during the period of initial ownership.

The fourth property is a residential building and undeveloped land known as "ISU House and Osaka land" in Osaka, Japan. Purchased in 1954, the house was used by office personnel when visiting Japan. Citibank, N.A.'s Corporate Realty Services handled management responsibilities during the years in issue.

The original purpose for acquiring each building was to an extent to house Citicorp/Citibank, N.A. personnel.

During the years in issue and prior to the sale of each of the four buildings, plaintiffs included the original cost of each building in the denominator of the property factor used to determine the portion of plaintiffs' business income attributable to California sources. Plaintiffs also included rental income and expenses associated with the management of each building in determining plaintiffs' business income attributable to California sources.

Separate and apart from the Board's audit of the years in issue, the Board determined that $645,149 of the refund due to plaintiffs for income year ended December 31, 1985 should be applied to an alleged balance due of accrued interest on taxes owing for income year ended December 31, 1994.

DISCUSSION

I.

California imposes a franchise tax on every corporation doing business within the state. (Rev. & Tax. Code,

§ 23151.)[1] The measure of a corporation's franchise tax is income derived from or attributable to California sources. (§ 25101.)

Unitary business principles describe a method of taxation whereby a business conducted by related taxpayers as a single economic enterprise and which earns income both within and without California is treated as one unit for determining income derived from or attributable to the state. (*Tenneco West, Inc. v. Franchise Tax Bd.* (1991) 234 Ca1.App.3d 1510, 1518-1519.) Where a corporation conducting business in California is part of a larger unitary business, the measure of its franchise tax liability (income attributable to California sources) is determined by reference to the unitary business income of all of the members of the unitary group. (§ 25101; *see Butler Brothers v. McColgan* (1941) 17 Ca1.2d 664, 667-668, *aff'd.* (1942) 315 U.S. 501 [86 L.Ed.2d 991, 62 S.Ct. 701]; *Edison California Stores v. McColgan* (1947) 30 Ca1.2d 472, 478-479.)

The portion of the business income of a unitary group attributable to California sources is determined by multiplying the unitary business income by a three-factor apportionment formula, as outlined in the Uniform Division of Income for Tax Purposes Act ("UDITPA") (§§ 25120-25139), which has been adopted by at least 23 states. The apportionment formula consists of a fraction which is determined by the level of a unitary group's sales, payroll, and property in California (numerator) compared to its sales, payroll, and property throughout

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[1] All statutory references are to the Revenue and Taxation Code.

the world (denominator). (§§ 25128-25137; *Edison California Stores, supra,* 30 Cal.2d at pp. 476-477, 480.) Once the California source income of the unitary group is determined, it is then apportioned among the corporations in the unitary group that are California taxpayers. Each California taxpayer corporation then merges its share of business income with all other separate income from California sources in arriving at its separate tax liability.

Both the United States Supreme Court and the California Supreme Court have long upheld California's use of a three-factor apportionment formula to fairly measure the appropriate amount of unitary business income attributable to those members of a unitary group subject to tax in California. *(Container Corporation of America v. Franchise Tax Board* (1983) 463 U.S. 159 [77 L.Ed.2d 545, 103 S.Ct. 2933]; *Butler Brothers v. McColgan, supra,* 17 Cal.2d 664, *aff'd.* (1942) 315 U.S. 501 [86 L.Ed.2d 991, 62 S.Ct. 701]; *Edison California Stores v. McColgan, supra,* 30 Cal.2d 472.)

For purposes of the sales factor of California's three-factor apportionment formula, sales are generally treated as having occurred in the state of their destination. Thus, sales are included in the numerator of the California sales factor if they occur in California. However, if the "taxpayer" is not taxable in the state of destination, sales are treated as having occurred in the state of origin. (§ 25135, subd. (a)(2).) In such a case, sales into California from another state would not be included in the numerator of the California sales factor.

The primary controversy arising from this action is a question of law, i.e., whether the sales and property of

Citibank (South Dakota), N.A. should be included in the numerator of the sales and property factors used to determine the portion of plaintiffs' income derived from or attributable to California sources.

Plaintiffs contend that the California sales (receipts) of Citibank (South Dakota), N.A. must be thrown back to the state of origin outside California pursuant to section 25135 because Citibank (South Dakota), N.A. is not individually taxable in this state.

The Board contends that the term "taxpayer," as used in section 25135, refers not merely to the seller corporation individually, but to all members of the unitary group. Thus, inasmuch as a number of members of plaintiffs' unitary group are undisputedly taxable in California, the sales of Citibank (South Dakota), N.A. must be assigned to the state of destination (California). The Board contends that these sales were therefore properly included in the numerator of the California sales factor of the three-factor apportionment formula.

The Board based its actions on a series of decisions originating from the State Board of Equalization ("SBE"), which is the administrative agency charged with interpreting the tax laws of this state and resolving disputes with taxpayers under the Bank and Corporation Tax Law. In *Appeal of Finnigan Corporation* ("*Finnigan*"), Cal. St. Bd. of Equal., Aug. 25, 1988, *Appeal of Finnigan Corporation* on rehearing ("*Finnigan II*"), Cal. St. Bd. of Equal., Jan. 24, 1990, and *Appeal of the NutraSweet Company* ("*NutraSweet*"), Cal. St. Bd. of Equal., Oct. 29, 1992, the SBE declared that for purposes of apportionment, the term "taxpayer" as used in section 25135 refers not to the seller

corporation individually, but to the seller's unitary group as a whole. Accordingly, in *Finnigan*, the SBE held that sales made from California to another state (i.e., outbound sales) should not be "thrown back" to California even though the individual seller corporation was not taxable in the destination state if any other member of the seller's unitary group was taxable there. The SBE declared that those sales must be treated as sales in the state of destination under section 25135.

In *Finnigan II*, the SBE considered the matter further and expressly overturned its previous holding in *Appeal of Joyce, Inc.*, Cal. St. Bd. of Equal., Nov. 23, 1966. In *Joyce*, the SBE had held that sales of goods shipped to California customers by a seller that was part of a combined group of corporations conducting a unitary business in California could not be included in the numerator of the California sales factor because the individual seller was not taxable by California.

Finally, in *NutraSweet*, the SBE, faced with the factual mirror image of *Finnigan* (and the factual situation presented here), held that sales into California (i.e., inbound sales) from another state could not be "thrown back" to the state of origin, even though the individual seller corporation was not taxable in California, because other members of the seller's unitary group were taxable in this state. Noting that *Nutrasweet* and *Joyce* presented the same issue and fact pattern and that *Joyce* was overruled in *Finnigan II*, the SBE held that the California destination sales of the non-taxpayer member of the unitary group were properly included in the numerator of the sales factor used to determine the California source income of the unitary group.

For the reasons discussed below, the Court finds the discussion and analysis in the decisions of *Finnigan* and its progeny to be persuasive as to the proper construction of "taxpayer" as used in section 25135. Although the Court recognizes that administrative decisions such as *Finnigan* are not binding on this Court, they are nonetheless entitled to consideration and respect and may be cited for their persuasive value and followed in the absence of controlling higher authority. (*Yamaha Corp. of America v. State Bd. of Equalization* (1998) 19 Cal.4th 1, 7; 9 Witkin, Calif. Proc. 4th (1997), Appeal, § 922, p. 960.) In evaluating the deference to be afforded to *Finnigan*, the Court notes the absence of any controlling California legal authority which has expressly rejected *Finnigan* and its progeny.

First, the Court finds that *Finnigan* embodies the statutory interpretation of section 25135 which is most consistent with fundamental unitary business principles. The underlying premise of the three-factor apportionment formula is that the income of the entire unitary group of corporations, and the group's factors, must be taken into account in determining the proper amount of income which has a California source. Thus, including the sales, property and payroll of all members of the unitary group ensures that the factors used to determine the California source income of the unitary group most closely reflects the level of activity conducted by the unitary group within the state. (*Edison California Stores v. McColgan, supra,* 30 Cal.2d at p. 479.)

Second, the Court is not persuaded by plaintiffs' contention that inclusion of the property and sales of Citibank (South Dakota), N.A. in the numerator of the

sales factor results in the unlawful taxation of a corporation not subject to California tax. Whether California has jurisdiction to tax any particular member of a unitary group is not significant for apportionment purposes. The California Supreme Court has determined that the unitary business formula apportionment method is designed only to determine the appropriate amount of income of those members of plaintiffs' unitary group which are in fact taxable in California and does not result in a tax on those members which are not subject to California tax. (*Edison California Stores v. McColgan, supra,* 30 Cal.2d at p. 481, 483.)

The Court finds that California has not taxed the sales of Citibank (South Dakota), N.A. by assigning its sales to California in the numerator of the sales factor of the apportionment formula. Its sales are simply being considered as one of the factors used to determine the amount of California source income of plaintiffs' unitary group upon which the California taxpayers of the unitary group are to be taxed. Inclusion of the sales of a unitary group subsidiary which does not engage in business in the taxing state in the apportionable tax base of the unitary group does not result in the taxation of income of the nontaxable subsidiary. (*Edison California Stores v. McColgan, supra,* 30 Cal.2d at. p. 481, 483.)

Third, the Court rejects plaintiffs' contention that the apportionment of the business income of a unitary group ignores the separate corporate identity of unitary group members. (*Butler Brothers, supra,* 17 Cal.2d 664; *Edison California Stores, supra,* 30 Cal.2d 472.) The California Supreme Court has determined that "[t]he ascertainment

of income by the apportionment method is not necessarily a disregard of the corporate entity nor an extension of the provisions of the statute by implication." (*Id.*, at p. 481.) A corporation which is a member of a unitary group is still treated by California as a distinct legal entity with a separate tax liability. Indeed, a unitary group of corporations is not taxable as a single entity. (See *Safeway Stores, Inc. v. Franchise Tax Board* (1970) 3 Cal.3d 745, 754.) "Formula allocation is merely a method of ascertaining the true income attributable to [a taxpayer's business], and is a method of ascertainment authorized by the statute." (*Edison California Stores, supra,* 30 Cal.2d at p. 481.) The separate identity of each taxpayer member of a unitary group thus remains intact.

Fourth, the Court finds that *Finnigan* is fully consistent with the fundamental unitary business principle that different apportionment consequences should not result from formal differences in the organization of a unitary business. The California Supreme Court has held that formula apportionment of income was applicable to a single corporation which operated separate corporate divisions within and without California (*Butler Bros. v. McColgan, supra,* 17 Cal.2d 664), as well as when business operations were conducted as corporate subsidiaries. (*Edison California Stores v. McColgan, supra,* 30 Cal.2d 472.)

The Court finds that *Finnigan* is consistent with *Butler Brothers* and *Edison California Stores* by equalizing the apportionment results between businesses conducted in single corporate form versus multiple corporate form. Had Citibank (South Dakota), N.A. operated as a division of plaintiffs' unitary group, as opposed to a corporate subsidiary, its sales would be included in the calculation

of income apportioned to California. Under *Finnigan*, the fact that Citibank (South Dakota), N.A. instead operated in the form of a subsidiary properly does not change the result.

Fifth, the Court finds that the interpretation given in *Finnigan* to "taxpayer," as that term is used in section 25135, to mean "all corporations within the combined unitary group," is fully consistent with the manner in which the Board has interpreted "taxpayer" in all other UDITPA provisions dealing with the mechanics of apportionment. Section 23037 defines "taxpayer" as "any person or bank subject to the tax imposed under [the Bank and Corporation Tax Law]." However, section 23030 provides a limitation on the definition of taxpayer in section 23037:

> "**Except where the context otherwise requires,** the definitions given in this chapter govern construction of this part." [Emphasis added.]

Thus, section 23030 provides that the definition of taxpayer generally means the separate or individual entity subject to tax in California "except where the context requires" a different interpretation.

A prime example where "the context otherwise requires" is in connection with the apportionment of income of a unitary business under the UDITPA provisions (§§ 25120 - 25139). Under unitary business principles, as embodied in the UDITPA provisions, all corporations engaged in a unitary business both within and without California are treated as a single economic enterprise for state tax purposes. To confine "taxpayer"

as used in section 25135 to the separate corporation taxable in California, as plaintiffs suggest, would not only create disharmony among the UDITPA provisions, but would directly contravene fundamental unitary business principles. These principles provide for the consideration of the payroll, property and sales of **all** corporations of the unitary group, not merely those which are taxable in California, in the measure of unitary group income attributable to California activities.

By contrast, none of the provisions of the Revenue and Taxation Code (§§ 23151, 23038 & 23221) cited by plaintiffs which focus on an individual corporate taxpayer is either a UDITPA statute or refers to "taxpayer" in the context of combined reporting and apportionment of unitary business income. As such, they are simply not relevant to this case. The Court further notes that nothing in section 25135 requires California, in determining the amount of a unitary group's combined income to apportion to this State, to confine its focus to the sales of those unitary group members that have jurisdictional nexus with the State.

Sixth, plaintiffs' contention that the Board's application of *Finnigan* resulted in the taxation of income already taxed by South Dakota is without merit. Constitutional jurisprudence does not require the invalidation of an apportionment formula that may result in the taxation of income earned outside the taxing state. (*Container, supra,* 463 U.S. at p. 170.) Rough approximations of a taxpayer's activities in the taxing state are sufficient in the formula apportionment of income from a unitary business. (*Moorman Mfg. Co. v. Bair* (1978) 437 U.S. 267, 273 [57 L.Ed.2d

197, 98 S.Ct. 2340]; *Montgomery Ward & Co. v. Franchise Tax Bd.* (1970) 6 Cal.App.3d 149, 155.)

Constitutional jurisprudence requires only that a state tax apportionment formula have "internal consistency," such that if the apportionment formula under consideration were applied by every jurisdiction in which a unitary group conducted business, it would result in no more than all of the unitary business' business income being subject to tax. (*Container, supra,* 463 U.S. at p. 169.) The application of the "internal consistency" test does not depend on whether states other than the taxing state have in fact imposed a similar tax. (See *Tyler Pipe Inds. v. Dept. of Revenue* (1987) 483 U.S. 232, 247 [97 L.Ed.2d 199, 107 S.Ct. 2810].)

The Court finds that *Finnigan* satisfies the "internal consistency" test. If *Finnigan* were applied by every jurisdiction in which plaintiffs conducted business, none of the income attributed to California sources would be subject to tax elsewhere. To the extent that inclusion of the property and sales of Citibank (South Dakota), N.A. resulted in an increase in plaintiffs' California source income, that income would not be treated as attributable to South Dakota activities and thus would not be subject to tax in that state.

Seventh, the Court finds that *Finnigan* does not run afoul of the Commerce Clause, Due Process Clause, and Equal Protection Clause of the United States Constitution. Plaintiffs' argument as to the Commerce Clause and Due Process Clause is premised on what the United States Supreme Court has described as the "external consistency" requirement of fairness in the application of an

apportionment formula. Under that requirement, the application of a tax apportionment formula, such as California's unitary tax method, must actually reflect a reasonable sense as to how income is generated. (*Container, supra,* 463 U.S. at pp. 169-170.) An apportionment formula will not be invalidated unless the taxpayer can prove by clear and cogent evidence that the income attributed to the state is " 'out of all appropriate proportion to the business transacted by the [taxpayer] in that State' " or has " 'led to a grossly distorted result.' " (*Container, supra,* 463 U.S. at pp. 170, 181; *Trinova Corp. v. Michigan Dept. of Treasury* (1991) 498 U.S. 358, 379-381 [112 L.Ed.2d 884, 111 S.Ct. 818].)

The taxpayer's burden of proof on this issue is "steep if not insurmountable." (*Colgate-Palmolive Co. v. Franchise Tax Bd.* (1992) 10 Cal.App.4th 1768, 1785.) The United States Supreme court has noted that the three-factor apportionment formula used by California has not only "met our approval" but has become "something of a benchmark against which other apportionment formulas are judged." (*Container, supra,* 463 U.S. at p. 170.)

The Court finds that plaintiffs have failed to meet their "steep, if not insurmountable" burden of proof of demonstrating that the Board's apportionment of plaintiffs' income in accordance with *Finnigan* is "grossly distorted" or is "out of all appropriate proportion" to their California activities. Plaintiffs have presented no evidence to support their claim that the Board's apportionment of plaintiffs' income in accordance with *Finnigan* is "grossly distorted" or is "out of all appropriate proportion" to their California activities. Rather, plaintiffs simply assert that they are unfairly treated because they are

required to pay $5.2 million more in California tax as a result of the Board's adherence to *Finnigan* than under their proposed methodology. Yet, courts have consistently discredited the notion that a difference between the figures derived under two different accounting methods proves that one set of figures is distorted. Simply because the methodology advocated by plaintiffs produces a result different from that produced by the Board's apportionment formula under *Finnigan* does not mean that formula apportionment improperly attributes income. (*See Container, supra,* 463 U.S. at pp. 180-184; *Mobil Oil Corp. v. Commissioner* (1980) 445 U.S. 425, 438 [63 L.Ed.2d 510, 100 S.Ct. 1223]; *Edison California Stores, supra,* 30 Cal.2d at p. 483; *John Deere Plow Co. v. Franchise Tax Board* (1951) 38 Cal.2d 214, 224.) As such, plaintiffs have not come close to satisfying their considerable burden of proof.

The Court also rejects plaintiffs' equal protection claim. State tax classifications require nothing more than a rational basis to satisfy the Equal Protection Clause. (*General Motors Corp. v. Tracy* (1997) 519 U.S. 278, ___ [136 L.Ed.2d 761, 787, 117 S.Ct. 811, 830]; *Amerada Hess Corp. v. Director, Div. of Taxation, N. J. Dept. of Treasury (1989)* 490 U.S. 66, 80 [104 L.Ed.2d 58, 109 S.Ct. 1617.)

The Court finds that inclusion of the property and sales of all members, both taxable and nontaxable, of plaintiffs' unitary group is rationally related to fundamental unitary business principles which treat the business operations within and without California of all members of a unitary group as contributors to the income generated in the state. For this reason, the property and sales of each member of plaintiffs' unitary group were

properly considered in order to fairly determine the appropriate amount of unitary business income attributable to California.

Eighth, plaintiffs have directed the Court's attention to several out-of-state decisions, as well as the Board's briefs in *Finnigan*, statements from the Multistate Tax Commission and a proposed draft Board administrative regulation. Although informative, none of these materials is either persuasive or constitutes binding legal authority.

Ninth, the court finds that the Board's reliance on *Finnigan* does not conflict with *Current, Inc. v. State Board of Equalization* (1994) 24 Cal.App.4th 382. *Current* involved the permissible reach of section 6203, subdivision (g), which imposed a use tax collection obligation on retailers "owned or controlled by the same interests which own or control any retailer engaged in business in the same or similar line of business in this state." Based on this statute, the State Board of Equalization attempted to impose a use tax collection obligation on Current, Inc. – an out-of-state mail order company which lacked taxable nexus in its own right under the Commerce Clause of the United States Constitution – because it was owned by Deluxe Corporation, which was taxable in California. The Court of Appeal determined that the State Board of Equalization could not impose a use tax collection obligation on Current, Inc. simply because it was owned by another taxable entity on the ground that Current itself lacked sufficient taxable nexus with California. Thus, as applied to Current, Inc., section 6203, subdivision (g) was deemed unconstitutional. (*Id.*, at p. 391.)

By contrast, this case concerns the unitary business principles of combined reporting and apportionment of income under UDITPA, not an attempt to impose a tax on a nontaxable corporation. Because the Court has determined that the Board has made no attempt to impose any tax liability on Citibank (South Dakota), N.A., the holding in *Current* does not conflict with the use of the *Finnigan* method of apportionment of income under UDITPA provisions for calculating how much of plaintiffs' total unitary business income is attributable to business activities within California.

Finally, the Court observes that the Board's adherence to *Finnigan* will not necessarily operate to the detriment of a unitary group. Depending on the circumstances, *Finnigan* will increase the amount of California source income of some unitary groups but decrease the amount of California source income of other unitary groups. For instance, the unitary group in *Finnigan* itself argued in favor of interpreting "taxpayer" to include every member of the unitary group because such an interpretation worked to the group's advantage by reducing the amount of unitary group income apportionable to California. (Def. Exh. Nos. A, B, & C.)

For all of the above-stated reasons, the Court finds that plaintiffs have failed to demonstrate that the Board's inclusion of the property and sales of Citibank (South Dakota), N.A. in the numerator of the apportionment formula, in accordance with *Finnigan* and its progeny, was improper as a matter of law.

II.

A second area of dispute between the parties involves the proper classification for tax purposes of the gains derived from plaintiff's sale of four buildings during the years in issue. Plaintiffs contend that the gains from the sales qualifies as "nonbusiness income" and thus should be allocated entirely to the jurisdiction of their commercial domicile and not subject to tax in California. The Board contends that all of the gains were properly classified as "business income" and thus subject to apportionment in California.

UDITPA provisions distinguish between "business income," which is apportioned by formula among all states from which a corporation derives income, and "nonbusiness income," which is not apportioned, but allocated entirely to the commercial domicile of a taxpayer. Section 25120, subdivision (a) defines business income as:

> " . . . income arising from activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

Nonbusiness income is defined as all income other than business income. (§ 25120, subd. (d).) The income of a corporate taxpayer is presumed to be business income unless clearly classifiable as nonbusiness income. (Cal. Code of Regs., tit. 18, § 25120(a).)

The SBE, in its administrative role as interpreter of California's tax laws, has construed section 25120 to provide two alternative tests to determine whether income constitutes business income. Under the "functional" test, income from property qualifies as business income if the acquisition, management and disposition of the property were "integral parts" of the taxpayer's regular trade or business operations, regardless of whether the income was derived from an occasional or extraordinary transaction. (*Appeal of Borden*, Cal. St. Bd. of Equal., Feb. 3, 1977.) Under the "transactional" test, income qualifies as business income if the transaction or activity which gave rise to the income arose in the regular course of the taxpayer's trade or business. (*Appeal of Fairchild Industries, Inc.*, Cal. St. Bd. of Equal., Aug. 1, 1980.) If either test is satisfied, the income is classified as business income. (*Ibid.*)

Plaintiffs contend that no functional test exists for business income under section 25120, whereas the Board contends that the functional test is legally recognized in California.

The functional test for business income has long been recognized in California, dating back prior to the enactment of UDITPA. (See *Appeal of Borden, supra; Appeal of DPF, Inc.*, Cal. St. Bd. of Equal., Oct. 28, 1980; *Appeal of Fairchild Industries, Inc., supra.*) The pre-UDITPA decisions cited in *Borden* state that income from tangible or intangible property was considered business income "if the acquisition, management, and disposition of the property constituted integral parts of the taxpayer's unitary business operations." (*Appeal of Borden, supra.*) This language was incorporated largely intact into the second clause of

the definition of business income contained in UDITPA, at section 25120, subdivision (a).

The pre-UDITPA decisions also state that where the functional test is satisfied, income arising from such property is business income **"even if it arose from an occasional sale or other extraordinary disposition of the property."** [Emphasis added.] (*Ibid; Appeal of New York Football Giants, Inc.*, Cal. St. Bd. of Equal., Feb. 3, 1977.)

The Court notes that in the over 21 years since *Borden*, the California legislature has not deemed it necessary to modify the language of section 25120 in any manner as to suggest disapproval of the functional test. The California legislature was presumably aware of the SBE's interpretation and application of section 25120 from *Borden* and the many decisions which followed. (*El Dorado Oil Works v. McColgan* (1950) 34 Cal.2d 731, 739; *Coca-Cola Co. v. State Bd. of Equalization* (1945) 25 Cal.2d 918, 922.) That the legislature has not seen fit to modify section 25120 in any way since *Borden* determined that this statute embodies two alternative tests for business income strongly suggests legislative approval of this statutory interpretation. (*Ibid.*)

The existence of the functional test for business income has been furthermore expressly acknowledged in a number of states which have adopted the UDITPA definition of business income. (See *The Kroger Co. v. Department of Revenue* (1996) 673 N.E.2d 710, 714 (Ill.App. 1 Dist. 1996) [Illinois]; *Ross-Araco Corp. v. Commonwealth of Pennsylvania* (1993) 674 A.2d 691, 693 (Pa. 1996) [Pennsylvania]; *District of Columbia v. Pierce Associates* (1983) 462 A.2d 1129, 1131 (D.C.App. 1983) [District of Columbia];

Pledger v. Getty Oil Exploration Co. (1992) 831 S.W.2d 121, 125 (Ark. 1992) [Arkansas].) The SBE's application of this test for business income is thus consistent with many states which have enacted UDITPA and promotes uniformity of law. (See § 25138.)

Plaintiffs contend that even if the functional test for business income exists in California, that test was not satisfied here because business income encompasses only income arising in the regular course of the taxpayer's trade or business. Plaintiffs contend that Citibank, N.A. is not engaged in the real estate business and thus the gains from the sale of the buildings necessarily constitute non-business income.

The Board contends that both SBE decisions and the Board's administrative regulations have consistently interpreted the functional test in such a manner that gains from the sale of property will qualify as business income under the functional test even if it arises "from an occasional sale or other extraordinary disposition of the property."

The Court finds that the functional test is satisfied in this case. Each of the four buildings served as a significant office location for plaintiffs' unitary operations. Citibank, N.A. either acquired or constructed each of the four buildings in part to provide office space for its personnel. At the time of sale, each of the buildings was occupied, at least partly if not completely, by Citibank, N.A. personnel as part of plaintiffs' unitary business operations. (JS 22-25.) Indeed, the 399 Park Avenue office building was the corporate headquarters for Citicorp/Citibank, N.A. at the time of sale. (JS 22.) Another of the

office buildings was known as the "Citicorp Center." (JS 24.) Although not an office building, ISU House and Osaka Land was used by office personnel when visiting Japan. (Joint Exhibit 6.) Furthermore, the Corporate Realty Services department of Citibank N.A. managed all but one of the four buildings during each of the years in issue and managed the fourth building (Citicorp Center) during Citibank, N.A.'s initial ownership. (JS 22-25.) The Corporate Realty Services department was also responsible for leasing out the office space. (Joint Exhibit 6.) Citibank, N.A. itself disposed of each of the four buildings in question by sale in 1987. (JS 22-25.) Thus, based on the undisputed evidence, the Court finds that each element of the functional test for business income was satisfied here.

The Court is not persuaded by plaintiffs' contention that Citibank, N.A.'s sale of the four buildings constituted an "occasional" or "extraordinary" disposition of property. It was entirely appropriate for the Board to classify as business income the gains from the sale of property maintained through the resources of and used in furtherance of plaintiffs' business operations as attributable to the business as a whole and thus a "regular" part of plaintiffs' business operations.

The SBE's construction of section 25120 is supported by the Board's administrative regulation to section 25120. (Cal. Code of Regs., tit. 18, § 25120.) The Board's administrative regulations construing the California tax laws are "entitled to great weight, and the courts generally will not depart from such construction unless it is clearly erroneous or unauthorized." (*Container Corp. of America v. Franchise Tax Bd.* (1981) 117 Cal.App.3d 988, 1000; *Coca*

Cola Co. v. State Bd. of Equalization, supra, 25 Cal.2d at p. 921.) Regulation section 25120(c)(2) provides that gain from the sale of property will be treated as business income "if the property while owned by the taxpayer was used in the taxpayer's trade or business." This regulation recognizes the functional test by treating gain from the disposition of property as business income if the property was used in the taxpayer's trade or business. Furthermore, the regulation contains no requirement that the transaction giving rise to the gain must itself occur in the regular course of the taxpayer's trade or business.

Furthermore, Cal. Code of Regs., tit. 18, § 25120(c)(2) provides the following example of business income:

> "**Example (B)**: The taxpayer constructed a plant for use in its multistate manufacturing business and 20 years later sold the property at a gain while it was in operation by the taxpayer. The gain is business income."

This example makes the point that gain from the sale of an asset should be classified as business income if the asset was acquired and maintained in furtherance of the business, even when the transaction from which the gain arises is not a common occurence [sic].

Plaintiffs also contend that the transactional test was not satisfied in this case; the Board contends otherwise.

The undisputed evidence shows that (1) the Corporate Realty Services department was a part of Citibank, N.A.'s unitary business operations during the years in issue; (2) the Corporate Realty Services department was responsible for management of three of the four buildings during the years in issue and of the fourth building

during Citibank, N.A.'s initial ownership; (3) the Corporate Realty Services department was responsible for leasing out the office space of the buildings, from which income was derived; and (4) Citicorp/Citibank, N.A. originally financed all of the buildings. (JS 22-25; Joint Exhibit 6, p. 2.)

Additionally, the existence within Citibank, N.A.'s corporate structure of a "Corporate Realty Services" department by itself strongly suggests that real estate management and financing were an integral and ongoing part of plaintiffs' business operations. Presumably, this department was created in order to generate income for the unitary business. The department was responsible for managing not only Citibank, N.A.'s New York City subject buildings during all or some portion of the company's ownership, but also its overseas property in Osaka, Japan. The leasing activities of the department furthermore generated business income for Citibank, N.A. on an ongoing and regular basis. The ultimate disposition of each building represented the culmination of a real estate operation which was sufficiently extensive to manage properties both domestically and overseas.

Based on this evidence, the Court finds that Citibank, N.A. was engaged in the business of real estate management and financing and that these activities constituted an integral part of plaintiffs' worldwide unitary business operations such that the sale of the subject buildings occurred in the regular course of plaintiffs' trade or business. Thus, the income from those activities constituted income from the unitary business. The Court finds that the transactional test for business income is satisfied here.

Plaintiffs' own tax treatment of these buildings further supports the Board's position. During the years in issue and prior to the sale of the four buildings, plaintiffs included the original cost of each building in the denominator of the property factor used to determine plaintiffs' **business** income attributable to California sources. Plaintiffs also included rental income and expenses associated with the management of each building in determining plaintiffs' **business** income attributable to California sources. (JS 30.) Thus, plaintiffs' own actions demonstrate that the gains from the sale of each of the four buildings arose from transactions in the regular course of Citibank, N.A.'s real estate business operations.

Plaintiffs contend that the gains from the sale of the four buildings constitute nonbusiness income under the Board's own regulation (Cal. Code of Regs., tit. 18, § 25137-4.1). This regulation provides that "(a)ll income of banks and financial corporations shall be 'business income' unless the income arises from an investment or activity which is not a banking function." The Board contends that this regulation has no bearing on the propriety of its classification of the gains from the sale of the buildings as business income.

The Court finds that each of the four buildings was acquired or constructed for Citibank, N.A. office personnel and was being used, wholly or in part, by office personnel at the time of sale. As such, each of the buildings served a "banking function" as a corporate headquarters or location from which Citibank, N.A. conducted its banking business. The gains from the sale of these buildings thus were attributable to, or an integral part, of

a "banking function" withing [sic] the meaning of the Board's administrative regulation.

The Court further finds that, in any event, the regulation is not applicable to the sale of the subject buildings. As already discussed, plaintiffs were engaged not only in the business of banking, but also the business of providing a wide range of financial services, including real estate management and financing. (JS 5, 24, 25.) Because the sale of the four buildings was attributable to the unitary business activities of plaintiffs, which included a wide range of financial services, the regulation has no bearing to the characterization of the gains arising therefrom.

Furthermore, to the extent that the gains do not qualify as business income under plaintiffs' interpretation of the regulation, the Court finds that plaintiffs' interpretation of the regulation is at odds with the statutory language of section 25120 (and regulation section 25120(c)(2)), which provides for the functional test for business income. That statutory test essentially provides that the gains from the sale of property which is acquired and maintained through the resources of and in furtherance of the business should be attributed to the business as a whole. To the extent that plaintiffs' reading of regulation section 25137-4.1 alters or is inconsistent with the functional test contained in section 25120, it cannot be interpreted as such. Plaintiffs' erroneous administrative construction does not govern a court's interpretation of a statute. (*Hewlett et al. v. Squaw Valley Ski Corp.* (1997) 54 Cal.App.4th 499, 526.)

Plaintiffs contend that the taxation of the gains from the sale of the buildings violates the Due Process Clause and Commerce Clause of the United States Constitution. The Board contends otherwise.

The Court finds that each of the four buildings constituted an integral part of plaintiffs' business operations. As such, each of the buildings served an "operational" rather than an "investment" function when each of them was acquired (or constructed) and occupied (or used) by Citibank, N.A. office personnel. Even those portions of Citicorp Center and 55 Wall Street which were not occupied by plaintiffs served an operational function. Citibank, N.A.'s Corporate Realty Services department provided management services to 55 Wall Street during each of the years in issues, including those floors not occupied by plaintiffs. Moreover, the Corporate Realty Services department of plaintiffs' unitary business generated unitary business income by leasing out to third party lessees the office space which plaintiffs did not occupy.

Furthermore, as previously noted, during the years in issue and prior to the sale of the four buildings, plaintiffs admittedly included the cost of each building in the denominator of the property factor used to determine plaintiffs' **business income** attributable to California sources. Furthermore, plaintiffs included the rental income and expenses associated with the management of each building in determining plaintiffs' **business income** attributable to California sources. (JS 30.)

The evidence before the Court compels the conclusion that each of the subject buildings constituted an integral part of plaintiffs' unitary business and thus

served an operational function. As such, the Court finds that taxation of the gains from the sale of the buildings does not violate either the Due Process Clause or the Commerce Clause of the United States Constitution.

In conclusion, the Court finds that the gains from the sales of the four buildings satisfies both the functional test and the transactional test for business income. Accordingly, then Board's classification of the gains as business income was proper.

III.

The final dispute between the parties involves the Board's application of a portion of plaintiffs' tax refund for income year ended December 31, 1985 against a balance of accrued interest allegedly due on taxes of $6,830,148 owing for income year ended December 31, 1994. Plaintiffs contend that the Board's application of a portion of their refund was improper because no interest should have been assessed against this tax liability. The Board contends that it was entitled to assess interest on plaintiffs' tax obligation, but acknowledges that plaintiffs are entitled to a refund of a portion of the accrued interest.

The parties agree to the following facts: Plaintiffs' initial tax return for 1994, filed on October 16, 1995, reported an overpayment of tax of $12,819,813. Plaintiffs at that time elected to have the Board apply the overpayment to the following tax year as an estimated tax payment. The Board complied and credited $12,819,813 to the 1995 tax year as an estimated tax payment. Subsequently, in March 1996, plaintiffs filed an amended 1994 return

which reported an additional tax liability of $6,830,148. Notwithstanding plaintiffs' earlier election to apply the 1994 overpayment of $12,819,813 to 1995, plaintiffs attempted to apply retroactively a portion of the overpayment which had been applied to 1995 against the additional 1994 tax liability of $6,830,148. The Board instead applied a portion of plaintiffs' overpayment for 1995 to satisfy the additional tax liability for 1994 once plaintiffs filed their 1995 return on October 15, 1996. In the interim, interest had accrued on the unpaid additional tax for 1994. Interest continued to accrue up to the effective date that the Board credited the $6,830,148 unpaid 1994 tax liability with a portion of plaintiffs' 1995 overpayment. The outstanding interest assessed by the Board (starting from April 15, 1995) against plaintiffs in the amount of $645,149.42 was finally paid in July 1997 when, at the conclusion of the Board's audit of the years in issue, the Board applied a portion of plaintiffs' overpayment from income year ended December 31, 1985.

Plaintiffs contend that no interest should have been assessed on their additional 1994 tax liability because the Board had the full use and control of the overpayment which was ultimately used to satisfy their 1994 tax obligation throughout the entire period of time that interest accrued.

The Board contends that the assessment of interest on the unpaid 1994 tax liability properly began to accrue as of October 16, 1995, the date that plaintiffs elected to have the Board apply the 1994 overpayment to the following tax year as an estimated tax payment. The Board contends that as of that date, the Board could no longer use the 1994 overpayment to satisfy the outstanding 1994 tax

liability, thus rendering the tax obligation both "due and unpaid."

Because the Board has not issued regulations on this subject and the Revenue and Taxation Code substantially conforms with the Internal Revenue Code, the Board follows federal regulations, procedures, rulings and decisions. (FTB Legal Ruling 94-4.)

Section 19002, subdivision (e), provides:

> "If any overpayment of income tax is claimed as a credit against estimated tax for the succeeding taxable year, that amount shall be considered as a payment of estimated tax . . . for the succeeding taxable year, and no claims for credit or refund of the overpayment shall be allowed for the taxable year in which the overpayment arises." [Emphasis added.]

A taxpayer which elects to credit an overpayment of taxes as an estimated tax payment for a subsequent year may not file an amended return revoking the election. (*Georges v. U. S. Internal Revenue Service* (11th Cir. 1990) 916 F.2d 1520, 1521.) Such an election is binding both on the taxpayer and the taxing agency. (*Ibid.*; *Starr v. Comm'r* (7th Cir. 1959) 267 F.2d 148, 151; Rev. Rul. 77-339, 1977-2 C.B. 475; Rev. Rul. 55-448, 1955-2 C.B. 595.)

> "Once the elected amount is credited as a payment of estimated tax for the succeeding year, it loses its character as an overpayment for the year in which it arose and cannot be used to offset any subsequently determined increase in the tax for that year." (*Georges v. U.S. Internal Revenue Service, supra,* 916 F.2d at p. 1521; see Rev. Rul. 77-339; Rev. Rul. 55-448.)

Furthermore, where a taxpayer elects to have an overpayment credited to estimated tax for the succeeding tax year, interest may be properly assessed on a tax deficiency for the year in which the overpayment arises. (Rev. Rul. 77-339; Rev. Rul. 55-448.)

The Court finds that the Board could properly charge plaintiffs interest on a tax deficiency to compensate the State for plaintiffs' use of the money that rightfully belonged to the Board. Once plaintiffs made their election to have the Board apply their 1994 overpayment as an estimated tax payment for 1995, the Board was legally obligated to comply with this directive. Neither plaintiffs nor the Board could thereafter revoke that election by applying any part of the overpayment to satisfy a subsequently determined tax liability for 1994.

Accordingly, in March 1996, when plaintiffs filed their amended 1994 return reporting an additional tax obligation for that year, that 1994 liability immediately became both, "due and **unpaid.**" (*May Department Stores Co. v. United States* (1996) 36 Fed. Cl. 680; *Avon Products, Inc. v. United States* (3rd Cir. 1978) 588 F.2d 342, 344.) The Board was legally barred from applying any of the 1994 overpayment to satisfy this obligation by virtue of plaintiffs' earlier irrevocable election to have the Board apply it to their 1995 tax liability. Once plaintiffs made that election, the money lost its character as a 1994 overpayment and became an 1995 estimated tax payment.

Thus, interest on the 1994 deficiency properly began to accrue as of October 16, 1995, the date that plaintiffs created the 1994 tax deficiency by electing to apply the purported 1994 overpayment against its 1995 estimated

BEST AVAILABLE COPY

taxes. As of that date, the additional 1994 tax was both due and unpaid and the Board no longer had the use of the 1994 overpayment to satisfy this tax liability. (*May Department Stores Co. v. United States, supra,* 36 Fed.Cl. 680.)

Plaintiffs also contend that interest on the additional 1994 tax deficiency was improperly assessed because the funds ultimately applied by the Board against the deficiency were part of an overpayment, reported by plaintiffs on its initial 1994 return, for which they never received a benefit in a subsequent year.

The Board contends that the relevant inquiry is not whether the 1994 overpayment which plaintiffs directed the Board to use as a 1995 estimated payment was ultimately needed to satisfy plaintiffs' tax liability for 1995, but rather when the 1994 tax liability became "due and unpaid."

Under federal law, interest may be assessed on a tax deficiency for a given year only when the tax is both "due and unpaid." (*Avon Products, Inc., supra,* 588 F.2d 342; *May Department Stores Co. v. United States, supra,* 36 Fed. Cl. 680.) These decisions hold that a tax is considered "unpaid" as of the date that the taxpayer elects to credit a purported overpayment for that year to a subsequent year.

The Court finds the reasoning of *Avon Products* and *May Department Stores Co.* to be persuasive. Under these cases, plaintiffs' additional 1994 tax liability did not become "due and unpaid" until October 16, 1995, the date that plaintiffs directed the Board to apply the money from its purported 1994 overpayment to a subsequent tax year.

Accordingly, interest could lawfully be assessed from the date (October 16, 1995) that the Board no longer had use of the purported 1994 overpayment by virtue of plaintiffs' election. That interest properly continued to run until the date (July 1997) that all accrued interest was paid by the Board's application of the 1985 refund.

However, inasmuch as the assessment of interest began to run as of April 15, 1995 (the date that plaintiff's 1994 taxes were due), the Board acknowledges that plaintiffs are entitled to a refund to the extent that accrued interest was assessed prior to October 16, 1995, i.e., from April 15, 1995 through October 15, 1995. Accordingly, as determined by the Board, plaintiffs are entitled to a partial refund, plus applicable interest thereon, in the amount of $395,196.63 (calculated through November 2, 1998).

CONCLUSION

The Court hereby orders that plaintiffs are entitled to a partial refund in the amount of $395,196.63 (calculated through November 2, 1998), plus applicable interest thereon. However, in all other respects, the Court orders that plaintiffs take nothing from defendant and that judgment be entered in favor of defendant and against plaintiffs in the present action.

Defendant's motion to exclude plaintiffs' exhibits 7 through 15 is denied; plaintiffs' motion to exclude defendant's exhibits A through D is likewise denied. The Court has read and considered all exhibits submitted by the parties.

The parties are ordered to remove their respective exhibits from Dept. 002, 575 Polk Street by contacting Ms. Cynthia Mosley at 551-3683.

Dated: 3/1/99

/s/ Ollie Marie-Victoire
OLLIE MARIE-VICTOIRE
Judge of the Superior Court

APPENDIX D

Court of Appeal, First Appellate District,
Division One – No. A086925
S092919

IN THE SUPREME COURT OF CALIFORNIA
En Banc

(Filed Jan. 10, 2001)

CITICORP NORTH AMERICA INC. & AFFILIATES,
Plaintiffs and Appellants,

v.

FRANCHISE TAX BOARD, Defendant and Respondent.

Petition for review DENIED.

GEORGE
Chief Justice

APPENDIX E

STATE OF CALIFORNIA
FRANCHISE TAX BOARD
Mailing Address:
Legal Division
P.O. Box 1468
Sacramento, CA 95812-1468
(916) 369-3337

June 8, 1990
FTB NOTICE 90-3
410:BRL:CN-90-363

Re: Sales Factor Throwback; Revenue and Taxation Code § 25135

In the Appeal of Finnigan Corporation, 88-SBE-022, August 25, 1988, the State Board of Equalization (SBE) specifically ruled that the word "taxpayer" as used in Revenue & Taxation Code Section 25135(b)(2) means "all of the corporations within the unitary group." Therefore, the SBE held that when sales were shipped from California to another state by a member of a group conducting a unitary business in California, the throwback rule does not apply if any of the corporations within the unitary group is taxable in the other state. In the Appeal of Finnigan Corporation, Opn. on Pet. for Rehg., 88-SBE-022A, January 24, 1990, the SBE expressly overruled the apportionment rule announced in the Appeal of Joyce, Inc., Cal. St. Bd. of Equal., November 23, 1966, that the income attributable to the California activities of a corporation exempt from taxation by this state because of Public Law 86-272 had to be separately computed by application of the apportionment method and then

excluded from the measure of the franchise tax. In practice, the Joyce rule was accomplished by excluding from the numerator of the apportionment formula, but not the denominator, the California factors of corporations within the unitary group that were not themselves taxable by this state. Under Finnigan, this restriction no longer applies.

Accordingly, the Franchise Tax Board's administrative practice with respect to multi-entity apportionment formula rules previously governed by Joyce has now changed as follows:

1. Sales of goods shipped from California to other states are to be assigned to this state under the throwback rule only when none of the corporations within the unitary group is taxable within the destination state.

2. The California property, payroll and sales of each corporation within a unitary group will be taken into account in the apportionment of business income to this state, including amounts attributable to entities exempt from taxation in this state because of Public Law 86-272. The total business income thus apportioned to California will be assigned to the individual corporations taxable by this state by use of the "revised method" currently authorized by Legal Ruling 234, as modified in the following example.

EXAMPLE

Corporations A, B, and C are engaged in a unitary business.
Corporations A and C are taxable by California, but Corporation B is exempt from taxation in California under Public Law 86-272.

The basic computations necessary to determine the amounts of business income from California sources attributable to Corporations A and C are as follows:

COMBINED APPORTIONABLE INCOME	$1,000,000

APPORTIONMENT FACTORS:

APPORTIONMENT FACTORS:

	TOTAL EVERYWHERE	<---------- WITHIN CALIFORNIA ----------> CORP A	CORP B	CORP C	TOTAL CA
PROPERTY	$ 600,000	$ 24,000	$ 0	$ 36,000	$ 60,000
PAYROLL	400,000	14,000	0	26,000	40,000
SALES	5,000,000	150,000	450,000	400,000	1,000,000
COMBINED CALIFORNIA APPORTIONMENT FORMULA:					
PROPERTY PERCENTAGE		4.00%	0.00%	6.00%	10.00%
PAYROLL PERCENTAGE		3.50%	0.00%	6.50%	10.00%
SALES PERCENTAGE		3.00%	9.00%	8.00%	20.00%
TOTAL					40.00%
AVERAGE					13.33%
BUSINESS INCOME APPORTIONED TO CALIFORNIA:					$ 133,333

LR 234 "REVISED METHOD" – RELATIVE FORMULA PERCENTAGE CALCULATION

	CORP A	CORP B	CORP C	TOTAL CA
PROPERTY FACTOR %	4.00%	N/A	6.00%	10.00%
PAYROLL FACTOR %	3.50%	N/A	6.50%	10.00%
SALES FACTOR %	3.00%	N/A	8.00%	11.00%
TOTAL PERCENT	10.50%	N/A	20.50%	31.00%
AVERAGE PERCENT	3.50%	N/A	6.83%	10.33%
RELATIVE PERCENT	33.87%	0.00%	66.13%	100.00%
BUSINESS INCOME APPORTIONED TO EACH CALIFORNIA TAXPAYER	$45,161	$0	$88,172	$133,333

DRAFTING INFORMATION

The principal author of this notice is Bruce R. Langston, Senior Staff Counsel, Franchise Tax Board Legal Division. For further information regarding this notice, contact Mr. Langston at P.O. Box 1468, Sacramento CA, 95812-1468.

bcc: Information Files: Apportionment-UDITPA-Sales Factor

APPENDIX F

Cal. Rev. & Tax. Code § 25120 (1992)

§ 25120. Definition of terms used in "this act"

As used in Sections 25120 and 25139, inclusive, which shall hereafter be referred to as "this act," unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

(b) "Commercial domicile" means the principal place from which the trade or business of the taxpayer is directed or managed.

(c) "Compensation" means wages, salaries, commissions and any other form of remuneration paid to employees for personal services.

(d) "Nonbusiness income" means all income other than business income.

(e) "Sales" means all gross receipts of the taxpayer not allocated under Sections 25123 through 25127 of this code.

(f) "State" means any state of the United States, the District of Columbia, the Commonwealth of Puerto Rico, any territory or possession of the United States, and any foreign country or political subdivision thereof.

Cal. Rev. & Tax. Code § 25121 (1992)

§ 25121. Income taxable both within and without state; Allocation and apportionment

Any taxpayer having income from business activity which is taxable both within and without this state shall allocate and apportion its net income as provided in this act.

Cal. Rev. & Tax. Code § 25128 (1992)

§ 25128. Formula for apportioning business income to state

All business income shall be apportioned to this state by multiplying the income by a fraction, the numerator of which is the property factor plus the payroll factor plus the sales factor, and the denominator of which is three.

Cal. Rev. & Tax. Code § 25129 (1992)

§ 25129. Formula for determining property factor

The property factor is a fraction, the numerator of which is the average value of the taxpayer's real and tangible personal property owned or rented and used in this state during the income year and the denominator of which is the average value of all the taxpayer's real and

tangible personal property owned or rented and used during the income year.

Cal. Rev. & Tax. Code § 25132 (1992)

§ 25132. Formula for determining payroll factor

The payroll factor is a fraction, the numerator of which is the total amount paid in this state during the income year by the taxpayer for compensation, and the denominator of which is the total compensation paid everywhere during the income year.

Cal. Rev. & Tax. Code § 25134 (1992)

§ 25134. Formula for determining sales factor

The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the income year, and the denominator of which is the total sales of the taxpayer everywhere during the income year.

Cal. Rev. & Tax. Code § 25138 (1992)

§ 25138. Construction of act; Construction of provisions of Multistate Tax Compact

This act shall be so construed as to effectuate its general purpose to make uniform the law of those states

which enact it. Enactment of Article IV of the Multistate Tax Compact (as set forth in Section 38006 of the code) pertaining to the allocation and apportionment of income shall be construed as a reenactment of Sections 25120 to 25137, inclusive, without any inference that a change in interpretation is implied by such enactment.

Cal. Code Regs. tit. 18, § 25137-4

25137-4 Banks and Financial Corporations – Allocation and Apportionment of Income.

(a) Definitions.

(1) "Receipts" for sales factor purposes means gross income including net taxable gain on disposition of assets derived from transactions and activities in the regular course of the taxpayer's trade or business which produce business income.

(2) "Participation loans" means joint loans by more than one bank to a common borrower.

(3) "Business situs" shall be the place at which intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with the taxpayer's business so that substantial use or value attaches to the property.

(b) Business and Nonbusiness Income. All income of banks and financial corporations shall be "business income" unless the income arises from an investment or activity which is not a banking function.

(c) Apportionment of Business Income.

The property, payroll and sales factors of the apportionment formula for banks and financial corporations shall be computed pursuant to Sections 25128 through 25137 of the Revenue and Taxation Code and the regulations adopted pursuant thereto except as provided in this regulation.

(1) Property Factor.

(A) In General.

(i) Owned intangible personal property shall be included at its tax basis for federal income tax purposes. Goodwill shall not be included in the property factor.

(ii) Coin and currency shall be taken into account for property factor purposes.

(B) The numerator of the property factor shall include, in addition to items otherwise assigned thereto, the following:

(i) Coin and currency located in this state.

(ii) Intangible personal property owned and used in the business determined as follows:

(I) Assets in the nature of loans (including federal funds sold and banker's acceptances) and installment obligations shall be attributed to this state if the office of the bank or financial corporation at which the customer applied for the loan is located in this state except in cases where the loan is recognized by appropriate banking regulatory authority as being made from and as an asset of an office located in another state, in which case it shall

be attributed to the state where that office is located. For purposes of this subclause, the word "applied" means initial inquiry (including customer assistance in preparing the loan application) or submission of a completed loan application, whichever occurs first in time.

(II) A participating bank's portion of a participation loan shall be attributed to this state if the office which enters into the participation is located in this state.

(III) Loans initiated through solicitation by traveling loan officers shall be attributed to this state if the office out of which such officer operates is located in this state except in cases where the loan is recognized by appropriate banking regulatory authority as being made from and as an asset of an office located in another state, in which case it shall be attributed to the state where that office is located.

(IV) Bank credit card and travel and entertainment credit card receivables shall be attributed to the state in which the credit card holder resides in the case of an individual or, if a corporation, to the state of the corporation's commercial domicile, provided the taxpayer is taxable in such state. If the taxpayer is not taxable in the state of the individual card holder's residence or commercial domicile of the corporate card holder, such receivables shall be attributed to this state if the taxpayer's commercial domicile is in this state.

(V) Investments of a bank fn securities, the income from which constitutes business income, shall be attributed to its commercial domicile except that:

a. Securities used to maintain reserves against deposits to meet federal and state reserve deposit requirements shall be attributed to each state based upon the ratio that total deposits in the state bear to total deposits everywhere.

b. Securities owned by a bank but held by a state treasurer or other public official or pledged to secure public or trust funds deposited in such bank shall be attributed to the banking office at which such secured deposit is maintained.

(VI) Investments of a financial corporation in securities, the income from which constitutes business income, shall be attributed to its commercial domicile unless the securities have acquired a business situs elsewhere in which case they shall be attributed to the state of such situs.

(iii) Where the taxpayer leases tangible personal property to another the entire cost of such property shall be attributed to the state of the taxpayer's commercial domicile unless the taxpayer establishes, or the Franchise Tax Board is able to establish the location of such property in another state or states for the entire year and the taxpayer is taxable in the state or states where the property is located.

(2) Sales Factor. Numerator. The numerator of the sales factor shall include, in addition to items otherwise assignable, the following:

(A) Receipts from the lease or rental of tangible personal property shall be attributed to the state of the taxpayer's commercial domicile unless the taxpayer or

the Franchise Tax Board is able to establish the location of such property in another state or states for the entire year and the taxpayer is taxable in the state or states where the property is located.

(B) Receipts from intangible personal property shall be included in the numerator as follows:

(i) Interest and other receipts from assets in the nature of loans (including federal funds sold and banker's acceptances) and installment obligations shall be attributed to this state if the office at which the customer applied for the loan is located in this state except in cases where the loan is recognized by appropriate banking regulatory authority as being made from and as an asset of an office located in another state, in which case it shall be attributed to the state where that office is located. For purposes of this clause, the word "applied" means initial inquiry (including customer assistance in preparing the loan application or submission of a completed loan application) whichever occurs first in time.

(ii) Interest income from a participating bank's portion of participation loan shall be attributed to this state if the office which enters into the participation is located in this state.

(iii) Interest income from loans solicited by traveling loan officers shall be attributed to this state if the office out of which such officer operates is located in this state except in cases where the loan is recognized by appropriate banking regulatory authority as being made from and as an asset of an office located in another state, in which case it shall be attributed to the state where that office is located.

(iv) Interest or service charges from bank, travel and entertainment credit card receivables and credit card holders' fees shall be attributed to the state in which the credit card holder resides in the case of an individual or, if a corporation, to the state of the corporation's commercial domicile, provided the taxpayer is taxable in such state. If the taxpayer is not taxable in the state of the individual card holder's residence or commercial domicile of the corporate card holder, the receipts shall be attributed to the state of the taxpayer's commercial domicile.

(v) Merchant discount income derived from bank and financial corporation credit card holder transactions with a merchant shall be attributed to the state in which the merchant is located, provided the taxpayer is taxable in such state. If the taxpayer is not taxable in the state in which the merchant is located, the merchant discount income shall be attributed to the state in which the taxpayer's commercial domicile is located.

(vi) Receipts for the performance of fiduciary services are attributable to this state if the services are principally performed in this state.

(vii) Receipts from investments of a bank in securities, the income from which constitutes business income, shall be attributed to its commercial domicile except that:

(I) Receipts from securities used to maintain reserves against deposits to meet federal and state reserve deposit requirements shall be attributed to each state based upon the ratio that total deposits in the state bear to total deposits everywhere.

(II) Receipts from securities owned by a bank but held by a state treasurer or other public official or pledged to secure public or trust funds deposited in such bank shall be attributed to the banking office at which such secured deposit is maintained.

(viii) Receipts (fees or charges) from the issuance of travelers checks and money orders shall be attributed to the state where the taxpayer's office is located that issued the travelers checks. If the travelers checks are issued by an independent representative or agent of the taxpayer, the following rules apply:

(I) If the taxpayer is taxable in the state in which the independent representative or agent issues the travelers checks or money orders, the receipts (fees or charges) shall be attributed to that state.

(II) If the taxpayer is not taxable in the state in which the independent representative or agent issues the travelers checks or money orders, the receipts (fees or charges) shall be attributed to the state of commercial domicile of the taxpayer.

(ix) Receipts from investments of a financial corporation, the income from which constitutes business income, shall be attributed to its commercial domicile unless the securities have acquired a business situs elsewhere in which case they shall be attributed to the state of such situs.

APPENDIX G

Affiliates of Citicorp North America, Inc.

Company Name

3325 Wilshire Blvd.
AMCAL Mortgage Corporation
Bankers Leasing & Financial Corporation
Bankers Leasing Corporation
Bay Defeasance Corporation
BLC Corporation
BLFC Securities Corporation
C.I.R.I. Corporation
California Village Place, Inc.
Carte Blanche International Ltd.
Carte Blanche Merchandising Company
CFIB, Inc.
Citi. Person-To-Person Financial Center (DE)
Citibank International
Citical, Inc.
Citicorp (USA), Inc.
Citicorp Acceptance Company, Inc. (CA)
Citicorp Acceptance Company, Inc. (DE)
Citicorp Acceptance Service Corp. (CA)
Citicorp Aircraft Management, Inc.
Citicorp Aviation Industry Resources, Inc.
Citicorp Business Credit, Inc.
Citicorp Capital Investors Ltd.
Citicorp Credit Service, Inc.
Citicorp Del-lease, Inc.
Citicorp Diners Club
Citicorp Diners Club, Inc.
Citicorp Financial Svcs., Inc.

Citicorp Homeowners, Inc.
Citicorp Information Resources, Inc.
Citicorp International Trading Co., Inc.
Citicorp Investment Management, Inc.
Citicorp Leasing, Inc.
Citicorp Management Logistics, Inc.
Citicorp Management Svcs., Inc.
Citicorp Nevada Credit, Inc.
Citicorp Nevada Leasing, Inc.
Citicorp Person-To-Person Financial Svcs.
Citicorp Person-To-Person Thrift, Inc. (CA)
Citicorp POS Information Svcs., Inc.
Citicorp Real Estate, Inc.
Citicorp Retail Svcs., Inc.
Citicorp Satellite Communication Svcs., Inc.
Citicorp Savings Service Corporation
Citicorp Savings, A Federal Savings & Loan
Citicorp Scrimgeour Vickers Int'l, Inc.
Citicorp Securities Markets, Inc.
Citicorp Svcs., Inc.
Citicorp Technoloffice, Inc.
Citicorp Trust (CA)
Citicorp Venture Capital Ltd.
Citicorp West, Inc.
Citimae, Inc.
Citishare Corporation
Clair-Del Gardens Realty, Inc.
Commetro Leasing, Inc.
Complan, Inc.
Digital Radio Network, Inc.
Diners Agency Svcs. Corp.
Diners World Travel, Inc.

DQM Corporation
Fame Software Corporation
Fields Realty, Inc.
Financial Leasing Corporation
Forrest Creek Holdings, Ltd.
Fox Real Estate Associates, Inc.
Hal-Mark Associates
Newbridge Securities, Inc.
Palm Defeasance Company
Person-To-Person Insurance Agency
Playland Realty Associates, Inc.
Prestige Gifts, Inc.
Quotron Systems International, Inc.
Quotron Systems, Inc.
Science Defeasance Corporation
Scripps Mesa Properties, Inc.
Securities Industry Software Corporation
Sierra Pines Holdings Ltd.
Six Sixty Shop, Inc.
The Commonwealth Plan, Inc.
The Commonwealth System, Inc.
The Pacific Plan, Inc.
The Worcester Plan, Inc.
Transaction Technology, Inc.
West Suburban Investments, Inc. of California

(2)

Supreme Court, U.S.
FILED
MAY 30 2001
CLERK

No. 00-1537

In The

Supreme Court of the United States

CITICORP NORTH AMERICA, INC. & AFFILIATES,

Petitioners,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

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COCKLE LAW BRIEF PRINTING CO., (800) 225-6964
OR CALL COLLECT (402) 342-2831

QUESTION PRESENTED

California imposes a franchise tax on all corporations doing business in the State. The measure of the franchise tax is a corporation's income attributable to California sources. When a corporation doing business in California is engaged in a unitary business enterprise with other corporations, and the unitary business does business both in and out of the State, California determines the income attributable to California sources through the unitary business formula apportionment method. This method apportions income by applying a constitutionally-approved three-factor apportionment formula to the business income of the unitary business to arrive at the amount of income of the unitary business attributable to activities within the State. The apportionment factors measure the income attributable to in-state activities by comparing the portion of the group's sales, property and payroll in the State to the total sales, property and payroll everywhere. Once the California-source income of the unitary business has been determined, it is allocated among the individual taxpayer members of the group doing business in the State in proportion to their factors in California. That amount is the measure of each corporation's franchise tax liability. Against this background, the following question is presented:

> May California constitutionally determine the California source income of the taxable members of a unitary group by using an apportionment formula that takes into account the apportionment factors of all members of the group, including the California factors of those group members that are not themselves taxable in the State?

LIST OF PARTIES

Respondent, Franchise Tax Board, accepts the List of Parties as stated by petitioners Citicorp North America, Inc. & Affiliates in the Petition for Writ of Certiorari.

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RESPONDENT'S BRIEF IN OPPOSITION

Respondent Franchise Tax Board ("Board") respectfully requests that this Court deny the Petition for Writ of Certiorari ("Petition") of petitioners Citicorp North America, Inc. & Affiliates (collectively, "Citicorp").

OPINIONS BELOW

The Board accepts Citicorp's statement of the Opinions Below as contained in its Petition and as reproduced at Appendix 1a-85a of the Petition.

STATEMENT OF JURISDICTION

The Board accepts Citicorp's statement of Jurisdiction as contained in its Petition.

CONSTITUTIONAL AND STATUTORY PROVISIONS INVOLVED

The Board accepts Citicorp's statement of the Constitutional and Statutory Provisions Involved as contained in its Petition and as reproduced at Appendix 92a-101a of the Petition. Additional statutory provisions are contained in Appendix A of the Board's Brief in Opposition to Petition for Writ of Certiorari.

STATEMENT OF THE CASE

This is an action for refund of California franchise taxes brought by Citicorp, a Delaware corporation and its affiliates located throughout the world, including California. Citicorp is part of a financial services organization engaged in a worldwide unitary business consisting of 550 domestic corporations, 88 of which were California taxpayers during the tax years ending December 31, 1985 through December 31, 1988 ("the years in issue").[1]

A. California's Method of Taxing Corporations Engaged in a Multistate Unitary Enterprise

California imposes a franchise tax on every corporation doing business within the State. Cal. Rev. & Tax. Code § 23151. The measure of that tax is the corporation's net income derived from or attributable to sources within

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[1] A unitary business is a functionally integrated economic enterprise characterized by substantial mutual interdependence and a flow of value among members of the unitary group. *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 178-179 (1983). Flows of value are described as "some sharing or exchange of value not capable of precise identification or sharing or exchange of value not capable of precise identification or measurement – beyond the mere flow of funds arising out of a passive investment or a distinct business operation – which renders formula apportionment a reasonable method of taxation." *Id.* at 166. A business is unitary when sufficient flows of value exist such that "contributions to income [result] . . . from functional integration, centralization of management, and economies of scale." *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 438 (1980), citing *Butler Brothers Stores v. McColgan*, 315 U.S. 501, 508-509 (1942).

California. Cal. Rev. & Tax. Code § 25101. When a corporation conducts business with affiliated corporations as part of a larger unitary business enterprise operating both within and without California, it becomes necessary to determine how much of the income of the unitary business is attributable to sources within California as opposed to another state. In other words, the income of the enterprise must be apportioned between California and other locations in which it conducts business. In these circumstances, business income derived from or attributable to California sources is determined on the basis of the unitary business formula apportionment method.[2] *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 162-163 (1983).

Unitary business formula apportionment is a method of apportioning income in which a business conducted by related corporations as a single economic (unitary) enterprise and which earns income both in and out of California is treated as one unit for determining income attributable to sources within the State. The proportion of the business income of a unitary business attributable to California sources is determined by applying a three-factor apportionment formula, as outlined in the Uniform

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[2] Business income is defined as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Cal. Rev. & Tax. Code § 25120(a). In contrast, nonbusiness income is defined as all income other than business income. Cal. Rev. & Tax. Code § 25120(d).

Division of Income for Tax Purposes Act ("UDITPA").[3] Cal. Rev. & Tax. Code §§ 25120-25139.[4]

California's three-factor apportionment formula is comprised of the average of three "factors." The *sales factor* is a fraction, whose numerator is the sales of the unitary group made in California during the year, and whose denominator is the unitary group's sales everywhere. Cal. Rev. & Tax. Code § 25134. The *property factor* is also a fraction, whose numerator is the property owned, rented or used by the unitary group in California during the year, and whose denominator is the group's property everywhere. Cal. Rev. & Tax. Code § 25129. The final factor is the *payroll factor*, whose numerator is the compensation paid in California, and whose denominator is compensation paid everywhere. Cal. Rev. & Tax. Code § 25132. The numerator of each of these three fractions or "factors" represents the value of sales, property or payroll of the unitary group within California, and the denominator of each fraction represents the value of sales, property or payroll of the group everywhere. For the years in issue, the apportionment factor was determined by adding the sales, property, and payroll factors and dividing by three.[5] Cal. Rev. & Tax. Code § 25128.

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[3] UDITPA was enacted in California in 1966 and has been adopted by over 20 states.

[4] Under regulations promulgated under authority of Cal. Rev. & Tax. Code § 25106.5, corporations engaged in a unitary business are required to file a "combined report" for the purpose of determining the amount of business income of the unitary group attributable to California sources.

[5] Section 25128 was amended, effective for taxable years beginning on or after January 1, 1994, to double-weight the sales

The apportionment factor is then applied to the world-wide business income of the unitary group to determine the amount of business income attributable to California sources.

Once the business income of the unitary group is apportioned by formula to California under combined reporting principles, the tax status of each California taxpayer member of the unitary group as a separate and distinct legal entity is taken into account. The income attributable to California sources is allocated among the individual members of the unitary group that are California taxpayers in proportion to each corporation's factors in California. This process is required so that each taxpayer's income attributable to California sources can be determined in arriving at its franchise tax liability.

This Court has observed that California's three-factor apportionment formula has not only "met our approval" against constitutional challenge made under the Due Process Clause and the Commerce Clause, but has become "something of a benchmark against which other apportionment formulas are judged." *Container Corp.*, 463 U.S. at 170.

B. California's Method of Computing the Factors of Its Apportionment Formula

The dispute in this case involves the method by which California determined Citicorp's California sales

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factor. Thus, the apportionment factor is currently determined for most taxpayers by adding the sales factor twice, the property factor and the payroll factor and dividing by four.

under the State's three-factor apportionment formula during the years in issue. Under California law, sales are generally assigned for apportionment purposes to the state of their destination if the "taxpayer" is subject to taxation in that state. Cal. Rev. & Tax. Code § 25135. However, if the "taxpayer" is not taxable in the state of destination, the sales are "thrown back" to the state of origin. Thus, if a "taxpayer" ships property from another state to a purchaser in California, and the "taxpayer" is taxable in California, the sale is considered to be a sale in California and is included in the numerator of the sales factor. On the other hand, if the "taxpayer" is not taxable in California, the sale is "thrown back" to the state of origin and deemed to be a sale outside California – and thus excluded from the numerator of the sales factor – for apportionment factor purposes.[6] The throwback rule arises from the fundamental premise of unitary business formula apportionment that all, but not more than all, of the income of a unitary business enterprise should be subject to taxation in the jurisdictions in which it does business.

For the years in issue, California determined that for purposes of apportionment, the term "taxpayer," as used

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[6] Cal. Rev. & Tax. Code § 25135 applies to the sale of tangible property. Although intangible property is generally not included in the sales factor, California regulations specially provide that banks and other financial institutions such as Citicorp are required to include intangible property, such as credit card receivables, in both their sales *and* property factors in accordance with statutory and regulatory provisions for the assignment of tangible property. 18 Cal. Code of Regs. § 25137-4 (now renumbered 25137-4.1).

in Cal. Rev. & Tax. Code § 25135, referred not to the individual member of the unitary group which made the sale, but rather to the seller's unitary group as a whole. *Appeal of Finnigan Corporation*, Cal. State Tax Rptr. (CCH) 1986-1990 transfer binder, ¶ 401-797 (August 28, 1988); *Appeal of Finnigan Corporation* on rehearing, Cal. State Tax Rptr. (CCH) 1986-1990 transfer binder ¶ 402-524 (January 24, 1990). Accordingly, a sale made by a California seller to a purchaser in another state (*i.e.*, an "outbound sale") could not be thrown back to California if any other member of the seller's unitary group was taxable in the destination state, irrespective of whether the individual seller corporation was itself taxable there. Rather, that sale was treated as a sale in the state of its destination under section 25135 and excluded from California's sales factor numerator. Conversely, a sale made by an out-of-state seller **into** California (*i.e.*, an "inbound sale") could not be thrown back to the state of origin, even if the individual seller corporation was not taxable in California, if any other member of the seller's unitary group was taxable in the State.[7] *Appeal of the NutraSweet Company*, Cal. State Tax Rptr. (CCH) 1992-1993 (Pt. 2) transfer binder ¶ 402-524 (October 29, 1992).

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[7] As will be discussed later, California has, since 1999, returned prospectively to a previously-used method of attributing unitary business income to the State which excludes from the apportionment formula the California factors of group members not taxable in the State.

C. California's Computation of Citicorp's California Sales for Apportionment Purposes

Citibank (South Dakota), N.A. ("Citibank South Dakota"), a member of Citicorp's unitary business during the years in issue, issued Visa and MasterCard credit cards. Citibank South Dakota had no physical presence (*i.e.*, tangible property or payroll) in California and was not subject to California franchise tax. However, Citibank South Dakota generated hundreds of millions of dollars in California sales receipts and credit card receivables to credit cards customers in California during each of the years in issue.

For each of the years in issue, Citicorp originally filed California franchise tax returns on a separate company basis. Citicorp later filed amended returns for each of the years in issue, taking the position that it engaged in a worldwide unitary business. Consequently, Citicorp determined its income attributable to California sources, and ultimately, its franchise tax liability on the basis of the California three-factor apportionment formula. The amended returns, which constituted claims for refund, sought tax refunds for each of the years in issue. Citicorp took the position in its amended returns that the value of the credit card sales and property generated by Citibank South Dakota to California customers should be excluded from the numerators (California factors) of the three-factor apportionment formula because Citibank South Dakota was not taxable in California.

The Board accepted Citicorp's amended position that it was engaged in a unitary business, but determined that the California sales (credit card receipts) and property

(credit card receivables) of Citibank South Dakota should be included in the numerators of the three-factor apportionment formula. Accordingly, the Board increased the numerator of Citicorp's sales factor by adding Citibank South Dakota's sales receipts from California credit card customers in the following amounts: $253,377,191 for 1985, $350,520,156 for 1986, $396,321,750 for 1987 and $478,974,131 for 1988. The Board also increased the numerator of Citicorp's property factor by adding Citibank South Dakota's credit card receivables from California customers in the following amounts: $1,364,590,734 for 1985, $1,694,273,294 for 1986, $2,303,098,005 for 1987 and $3,187,824,161 for 1988. This resulted in an increase in the apportionment of Citicorp's unitary group income to California by the following amounts: $12,826,406 for 1985, $11,558,073 for 1986, $9,083,509 for 1987 and $14,705,509 for 1988.

As a consequence, Citicorp's claims for refund were only partially granted. The portion of the claims for refund attributable to the exclusion of Citibank South Dakota's California sales and property from the apportionment factor numerators was denied.

D. Adjudication of the Federal Questions in the Proceedings Below

As a result of the Board's actions, Citicorp filed suit for a tax refund in the San Francisco County Superior Court. Citicorp alleged, in part, that California's method of apportioning income resulted in the unconstitutional taxation of the income of a nontaxable member (Citibank South Dakota) of its unitary business, in violation of the

Due Process Clause and the Commerce Clause of the United States Constitution. The trial court ruled that California's method of apportioning the sales of a corporation engaged in a unitary business was constitutional and rendered judgment in favor of the Board. Appendix 49a-84a of Petition.

Citicorp appealed. By unanimous decision, a three-member panel of the California Court of Appeal affirmed the judgment of the trial court. Appendix 1a-48a of Petition. The Court of Appeal rejected Citicorp's claim that California's apportionment method resulted in the indirect taxation of the income of Citibank South Dakota and concluded that California was actually imposing taxes "only on the corporations that are subject to California's taxing jurisdiction." Appendix 14a of Petition.

> Citibank (South Dakota) is not being subjected to a tax in this case. The relevant stipulated fact in this case is that Citicorp and its affiliates, including Citibank (South Dakota) "were conducting a worldwide unitary business during the years in issue, and their combined franchise tax liability must be computed on a unitary basis." The rule applied here results in recognition that the unitary group benefitted from sales in California.

Appendix 18a of Petition. Accordingly, the Court of Appeal found California's apportionment method to be "consistent with accepted principles of taxation of a unitary business." Appendix 15a of Petition. Furthermore, the Court of Appeal determined that Citicorp had failed to carry its burden of demonstrating that California's approach to attributing sales to California under its

apportionment formula violated either the Due Process Clause or the Commerce Clause. Appendix 29a-33a of Petition.

> There is nothing arbitrary or unconstitutional about assigning Citibank's (South Dakota) credit card sales and transactions actually occurring in California to California. Such an assignment reasonably recognizes the contribution of the state in producing the income of the unitary group. Citicorp has not shown the allocation to California is " 'out of all appropriate proportions to the business transacted . . . in that State. . . . ' " (*Container Corp. v. Franchise Tax Bd., supra,* 463 U.S. at p. 170.)

Appendix at 33a of Petition.

Citicorp sought review of the Court of Appeal's decision in the California Supreme Court. Without comment, the California Supreme Court denied Citicorp's petition for review. Appendix 85a of Petition.

REASONS FOR DENYING THE PETITION

This Court should deny review of the California Court of Appeal's decision affirming the validity of California's apportionment method for determining income of the taxable members of a unitary business attributable to California sources. Several reasons compel this conclusion.

First, Citicorp's arguments raise issues which have no ongoing legal significance in California. As of April 22, 1999, California has reverted prospectively to using a

previously-used apportionment method in which the California sales, property and payroll of nontaxable members of a unitary business, including Citicorp, are no longer attributed to California for purposes of computing the numerators of the group's sales, property and payroll factors.

Second, Citicorp's claim is a thinly-disguised attempt to undermine decades of authority from this Court permitting a taxing state to look beyond its borders to arrive at a fair allocation of its share of the taxable values of a taxpayer's activities within the state. Citicorp is undisputedly engaged in a unitary business. This Court has repeatedly and consistently rejected the contention that a state that takes into consideration for apportionment purposes the activities of nontaxable members of the unitary group is engaged in extraterritorial taxation. Citicorp's petition reflects a fundamental misapprehension between two distinct and separate concepts: a state's right to *apportion* the income of a unitary business to determine the proper state source of that income and a state's *jurisdiction* to tax individual corporations.

Third, Citicorp's position is based on the false premise that the separate identity (and thus, the separate income) of the individual members of a unitary group, such as Citibank South Dakota, should ultimately determine the group's collective tax liability. This premise is contrary to the fundamental unitary business principle that, for purposes of apportioning the appropriate share of the group's unitary business income to a state, the separate identity of the individual members of the unitary group may be ignored, because separate accounting

does not and cannot adequately reflect the many contributions to income and flows of value among members of a unitary group. Combined reporting operates on the constitutionally-approved principle that the income of the *entire* unitary group of corporations, and the group's factors, may be considered when apportioning income to the taxing state.

I. THE ISSUE BEFORE THIS COURT LACKS SUFFICIENT IMPORTANCE TO WARRANT A GRANT OF REVIEW

At the outset, certiorari should be denied because the issues raised in the Petition have no ongoing legal significance in California. As of April 22, 1999, California administratively changed, on a prospective basis, its method of assigning sales to the State by returning to a previously-used apportionment method, one in which the California sales, property and payroll of nontaxable unitary members are no longer attributed to California in computing the numerators of the group's sales, property and payroll factors. 18 Cal. Code of Regs. § 25106.5(c)(7)(B). Thus, for corporations doing business in the State, including Citicorp, the implications of the California Court of Appeal's decision have little, if any, ongoing impact. Citicorp's petition raises questions applicable only to the years in issue, already resolved twice in favor of California, and with little significance outside the limits of this case. Therefore, certiorari should be denied.

In any case, Citicorp misstates the significance of the California Court of Appeal's decision by characterizing it as "a serious threat to constitutional restraints on state

taxation." Petition at 22. In reality, what Citicorp seeks is to significantly erode many decades of decisional authority from this Court permitting a taxing state to look beyond its borders to arrive at a fair allocation to the state of a fair share of the taxable values of the taxpayer's activities within the state. *See, e.g., Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298, 311-12 n. 10 (1994); *Shell Oil Co. v. Iowa Dep't of Revenue*, 488 U.S. 19, 30-31 (1988); *Container Corp., supra*, 463 U.S. at 165; *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 219 (1980); *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425, 436 (1980); *Moorman Mfg. Co. v. Bair*, 437 U.S. 267, 273 (1978); *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450, 460 (1959). *See generally International Harvester Co. v. Evatt*, 329 U.S. 416 (1947); *Butler Brothers Stores v. McColgan*, 315 U.S. 501 (1942); *Hans Rees' Sons v. North Carolina ex rel. Maxwell*, 283 U.S. 123 (1931); *Bass, Ratcliff & Gretton, Ltd. v. State Tax Comm'n*, 266 U.S. 271 (1924); *Underwood Typewriter Co. v. Chamberlain*, 254 U.S. 113 (1920).

Never before in the history of state apportionment of income cases before this Court has a taxpayer successfully contended that a state's inclusion of the nontaxable income of a unitary group member, generated as part of the unitary business, in the apportionable income base of a unitary group member resulted in extraterritorial taxation. None of the cases cited by Citicorp that invalidated state exactions of extraterritorial income involved the apportionment of income of a unitary business or, more specifically, the prohibitions against a state considering, in the apportionment process, the activity and income of corporations whose connection to the taxing

state was that they were part of a unitary business operating there.[8] This Court has uniformly rejected such a notion on the ground that the apportionment of income is not tantamount to the taxation of income.

For instance, in *Shell Oil Co.*, 488 U.S. at 30-31, this Court upheld the inclusion in the State of Iowa's tax base of income generated from the Outer Continental Shelf and rejected an argument – that the inclusion of nontaxable income in the apportionable base of a state's tax results in the taxation of extraterritorial values – similar to that presented here:

> Shell's argument hinges on the mistaken premise that including OCS-derived income in the preapportionment tax base is tantamount to the direct taxation of OCS production. But income that is included in the preapportionment tax base is not, by virtue of that inclusion, taxed by the state. Only the fraction of total income that the apportionment formula determines (by multiplying the income tax base by the apportionment fraction) to be attributable to Iowa's

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[8] For example, in this Court's recent decision in *Hunt-Wesson, Inc. v. Franchise Tax Board*, 528 U.S. 458 (2000), the issue presented did not involve the proper apportionment of income of a unitary business doing business in California. Rather, the case involved the constitutionality of California's "interest offset deduction," (Cal. Rev. & Tax. Code § 24344), which, *after the apportionment of income to individual taxpayers*, operated to assign the interest expense deduction of a corporation as a deduction against nonbusiness income. This Court held that this assignment, as applied to out-of-state taxpayers whose nonbusiness income was not taxable in California, caused extraterritorial income to be taxed indirectly by the State in violation of the Due Process Clause.

> taxing jurisdiction is taxed by Iowa. As our Commerce Clause analysis of apportionment formulas has made clear, the inclusion of income in the preapportioned tax base of a state apportionment formula does not amount to extraterritorial taxation. This court has repeatedly emphasized that the function of an apportionment formula is to determine the portion of a unitary business' income that can be fairly attributed to instate activities. *Exxon Corp. v. Wisconsin Dept. of Revenue*, 447 U.S. 207, 219 (1980); *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 440 (1980).

It follows implicitly from these decisions that where, as here, income apportioned to the State is increased by consideration of the income and factors (such as sales to California customers) of the nontaxable members of the group, any increase in the tax base is properly borne by the taxable corporations. The combined reporting process utilized by California reflects the values in the State of the integration and interdependence of the taxable and nontaxable members of Citicorp's unitary business. Granting certiorari to affirm, yet again, what has long been a fundamental principle of state taxation law is unwarranted.

II. THIS COURT SHOULD DENY REVIEW BECAUSE THE CALIFORNIA COURT OF APPEAL'S DECISION IS FULLY CONSISTENT WITH THE WELL-SETTLED DECISIONS OF THIS COURT

A. California's Method of Apportioning Unitary Business Income to Its California Source Does Not Implicate the State's Jurisdiction to Tax Under the Due Process Clause or Commerce Clause

Citicorp attempts to make the case that California's apportionment method – which attributed to the State the credit card sales to California customers of a nontaxable member of Citicorp's unitary business, thereby increasing the tax base of Citicorp's members taxable in California – resulted in extraterritorial taxation. To the contrary, California's method of apportionment is fully consistent with constitutionally-approved principles of apportioning income for the purposes of taxation of the members of a unitary business.

Citicorp's attack on California's apportionment method suffers from two critical misconceptions.

First, it confuses a state's *jurisdiction* to tax with *apportionment* of income. Citicorp's contention that California's apportionment of income to its taxable members results in extraterritorial taxation solely because sales to California customers are made by a nontaxable member of the unitary business is contrary to the long line of well-established precedents of this Court approving the apportionment of income of unitary business enterprises. These decisions have consistently affirmed the fundamental unitary business principle that in apportioning the combined income of a unitary group of corporations, a state is

not constitutionally barred from taking into account the income and factors of all the members of the group, without regard to whether the members are subject to tax by the state.

> This method [unitary business formula apportionment], unlike separate accounting, does not purport to identify the precise geographical source of a corporation's profits; rather, it is employed as a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State.

Moorman Mfg. Co., 437 U.S. at 273. *See also Barclays Bank*, 512 at 311-12 n. 10; *Shell Oil Co.*, 488 U.S. at 30-31; *Container Corp.*, 463 U.S. at 165; *Exxon Corp.*, 447 U.S. at 219; *Mobil Oil Corp.*, 445 U.S. at 436; *Northwestern States Portland Cement Co.*, 358 U.S. at 460. *See generally Butler Bros.*, 315 U.S. 501; *Hans Rees' Sons*, 283 U.S. 123; *Underwood Typewriter Co.*, 254 U.S. 113. In so holding, this Court has declared that a "state's tax law is not to be nullified merely because the result is achieved through a formula which includes consideration of interstate and out-of-state transactions in their relation to the intrastate privilege," (*International Harvester Co.*, 329 U.S. at 423), and that in imposing an apportioned tax on doing business, a state may look "to the property of such corporations beyond its borders. . . . " *Bass, Ratcliff & Gretton, Ltd.*, 266 U.S. at 282.

The decision of the California Court of Appeal is fully consistent with these well-established decisions. In rejecting Citicorp's claim that California's attribution of Citibank South Dakota's sales to California in the apportionment formula results in extraterritorial taxation, the

Court of Appeal held that the State "is not taxing, but is apportioning income attributable to California. (*Edison California Stores v. McColgan, supra,* 30 Cal.2d 472, 474-475.) Taxes are actually imposed only on the corporations that are subject to California's taxing jurisdiction." Appendix 14a of Petition. California's attribution of Citibank South Dakota's credit card sales to California customers to the State "results in recognition that the unitary group benefitted from sales in California." Appendix 18a of Petition.

Second, Citicorp's attack on California's apportionment method is fatally flawed because it is based on the premise that the separate identity (and thus, the separate income) of individual members of its unitary group, such as Citibank South Dakota, should ultimately control the determination of the group's collective tax liability. In order to repeatedly complain that California's apportionment method results in the "shifting" of income from a nontaxable corporation to taxable corporations, Citicorp must necessarily segregate the income of its unitary business enterprise into the separate income of each of the individual member corporations. This segregation can only be accomplished through the mechanism of separate accounting, which this Court has held "is subject to manipulation and imprecision, and often ignores or captures inadequately the many subtle and largely unquantifiable transfers of value that take place among the components of a single enterprise." *Container Corp,* 463 U.S. at 164-165. Thus, Citicorp's argument disregards the undisputed fact that each of its unitary members, whether taxable or nontaxable in the State, constitutes an integrated part of a single unitary enterprise.

The premise of Citicorp's argument is fundamentally at odds with the underlying theory of unitary business formula apportionment as reflected in California's system of combined reporting: the separate identity of the individual members of the unitary group is disregarded for the purpose of determining the appropriate amount of the unitary group's combined income to apportion to the taxing state. *See Mobil Oil,* 445 U.S. at 439 ["the linchpin of apportionability in the field of state income taxation is the unitary business principle"]. Under combined reporting principles, the income and factors of the entire unitary group, not solely its taxable members, are properly considered in making that determination, because a state may tax a proportionate share of the "unitary" income of a nondomiciliary corporation that carries out a particular business both in and out of that state. *Allied-Signal v. Director, Division of Taxation,* 504 U.S. 762, 778 (1992). Thus, as the California Court of Appeal correctly observed in this case, the attribution of Citibank South Dakota's "credit card sales and transactions actually occurring in California to California . . . reasonably recognizes the contribution of the state in producing the income of the unitary group." Appendix 33a of Petition.

Simply put, California's apportionment method neither "shifts" nor "assigns" anything to or from one corporation to another or from one state to another. It merely apportions to the State a portion of Citicorp's unitary business income which reasonably approximates the level of business conducted by the unitary group in the State, *i.e.,* determines the income of the unitary group attributable to California sources. Income attributable to California sources, which is the measure of a corporation's tax

liability under California statutes, is then assigned to the members of Citicorp's unitary business taxable in the State.

Citicorp is undisputedly engaged in a unitary business. Because its business is not truly separate and distinct from the operations of the unitary group in California, its income may not be segregated clearly and accurately from its California operations. Thus, as the California Court of Appeal properly concluded, Citicorp's credit card sales to its California customers, regardless of the taxable or nontaxable status of the individual member of the unitary group that carries it out, may be appropriately considered in determining the appropriate amount of Citicorp's income that is attributable to California sources.

B. California's Apportionment Method Does Not Violate the Commerce Clause by Favoring In-State Over Out-Of-State Entities

Citicorp's allegation that California's apportionment method discriminates against interstate commerce is constructed on the same faulty premise as its allegation of extraterritorial taxation. By inappropriately ascribing its unitary business income to individual members of its unitary group, such as Citibank South Dakota, in an apportionment setting, Citicorp once again ignores fundamental principles of combined reporting and reverts to the separate accounting principles which this Court has previously rejected. *Container Corp.*, 463 U.S. at 164-165. Little, if anything, needs to be added to the Board's

previous response: the tax liability of a group of corporations engaged in a unitary business both within and without the state is appropriately measured not by reference only to the taxable status of individual members of the unitary business, but rather, by reference to the activities of the entire unitary group through the use of an objective three-factor apportionment formula that "has become . . . something of a benchmark against which other apportionment formulas are judged." *Id.* at 170.

California's method of apportionment does not discriminate against interstate commerce, because the measure of the State's franchise tax does not depend on the state where a corporation is domiciled or conducts its business. To illustrate, during the years in issue, California treated "inbound sales" to the State in exactly the same manner as "outbound sales" from the State, *i.e.*, sales were not "thrown back," or attributed to their state of origin when any member of the unitary group was taxable in the state of destination. Consequently, when this apportionment method was applied to "outbound sales," it actually had the effect of *reducing* the income base of the taxable members of the group taxable in California.

Citicorp's reliance on *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996) is misplaced. The state taxing scheme condemned in that case did not arise in the context of the apportionment of income of a unitary business doing business in the state. Moreover, the attribution to California of the credit card sales to California customers made by Citibank South Dakota was not the result of its nontaxable status. Under California's apportionment method,

the credit card sales would have been included in Citicorp's California sales numerator regardless of the taxable or nontaxable status of Citibank South Dakota.

This Court has observed that "[a]t least in the interstate commerce context . . . the anti-discrimination principle has not in practice required much in addition to the requirement of fair apportionment." *Container Corp.*, 463 U.S. at 171. No "penalty" of nontaxable members of a unitary business is inherent in California's methodology.

C. California's Apportionment Method Fairly Approximates Citicorp's Level of Unitary Business Activity Within the State

California's apportionment method does not violate the Commerce Clause requirement of fair apportionment by "shifting" the income of a nontaxable corporation to a taxable corporation. Once again, by attempting to attach income and apportionment factors to individual members of an integrated unitary business enterprise, Citicorp inappropriately injects separate accounting principles into the apportionment process. In so doing, Citicorp ignores the basic purpose and rationale of apportionment.

On the most fundamental level, there is nothing arbitrary or unfair about attributing Citicorp's credit card sales made in *California* and to *California* customers to *California*. Including such sales in the California based numerators of the apportionment formula reasonably reflects how income is generated in the State. Citicorp's contention that the unitary business income apportioned to California was out of all appropriate proportion to its

activities in California is demonstrably false: although credit card sales receipts to Citibank South Dakota from California customers during the years in issue ranged from over $253 million to in excess of $478 million and credit card receivables from California customers ranged from over $1.3 billion to over $3.1 billion, the additional unitary income apportioned to the State increased only by amounts ranging from approximately $9 million to less than $15 million. The California Court of Appeal properly found that Citicorp had failed to present any evidence at trial to support its allegation that California's apportionment scheme grossly distorted the amount of unitary business income allocable to California. Appendix 31a of Petition. On the contrary, the Court of Appeal concluded, "the evidence reflected the reasonable apportionment of sales generated in California." Appendix 31a of Petition.

Including sales in California's apportionable tax base notwithstanding that the individual seller (Citibank South Dakota) in Citicorp's unitary group was not itself taxable in California is the apportionment method that is most consistent with the fundamental theory of unitary business formula apportionment. While a state is perfectly free to exclude consideration of such sales in the determination of its apportionable income base, as California has done prospectively, there is no provision in the Constitution that requires it to do so. If the sales of Citibank South Dakota must be excluded from the apportionable income base under the Constitution, it would follow that all sales of goods to a state by a member of a unitary group that is nontaxable in the destination state would have to be excluded from the numerator of the

state's sales factor. Such a result would hardly reflect a reasonable apportionment of income among the jurisdictions in which the unitary business conducts its activities which, after all, is the ultimate goal of formula apportionment. Indeed, it would have just the opposite effect. More importantly, Citicorp has failed to cite a single authority interpreting the limitation on the states' powers of taxation in this manner.

CONCLUSION

For all of the foregoing reasons, the petition for writ of certiorari should be denied.

Respectfully submitted,

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APPENDIX A

RELEVANT CALIFORNIA STATUTES

Cal. Rev. & Tax Code § 23151 (1997)

§ 23151. Imposition and rate of tax

(a)With the exception of banks and financial corporations, every corporation doing business within the limits of this state and not expressly exempted from taxation by the provisions of the Constitution of this state or by this part, shall annually pay to the state, for the privilege of exercising its corporate franchises within this state, a tax according to or measured by its net income, to be computed at the rate of 7.6 percent upon the basis of its net income for the next preceding income year, or if greater, the minimum tax specified in Section 23153.

(b) For calendar or fiscal years ending after June 30, 1973, the rate of tax shall be 9 percent instead of 7.6 percent as provided by subdivision (a).

(c) For calendar or fiscal years ending in 1980 to 1986, inclusive, the rate of tax shall be 9.6 percent.

(d) For calendar or fiscal years ending in 1987 to 1996, inclusive, and for any income year beginning before January 1, 1997, the tax rate shall be 9.3 percent.

(e) For any income year beginning on or after January 1, 1997, the tax rate shall be 8.84 percent. The change in rate provided in this subdivision shall be made without proration otherwise required by Section 24251.

Cal. Rev. & Tax Code § 25101 (1982)

§ 25101. Basis of Allocation

When the income of a taxpayer subject to the tax imposed under this part is derived from or attributable to sources both within and without the state the tax shall be measured by the net income derived from or attributable to sources within this state in accordance with the provisions of Article 2 (commencing with Section 25120). However, any method of apportionment shall take into account as income derived from or attributable to sources without the state, income derived from or attributable to transportation by sea or air without the state, whether or not the transportation is located in or subject to the jurisdiction of any other state, the United States or any foreign country.

If the Franchise Tax Board reapportions net income upon its examination of any return, it shall, upon the written request of the taxpayer, disclose to it the basis upon which its reapportionment has been made.

Cal. Rev. & Tax Code § 25135 (1966)

§ 25135. Determination of sales in this state of tangible personal property for inclusion in sales factor

Sales of tangible personal property are in this state if:

(a) The property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f.o.b. point or other conditions of the sale; or

(b) The property is shipped from an office, store, warehouse, factory, or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser.

Supreme Court, U.S.
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No. 00-1537

IN THE
Supreme Court of the United States

CITICORP NORTH AMERICA, INC. & AFFILIATES,
Petitioner,

v.

FRANCHISE TAX BOARD,
Respondent.

On Petition for a Writ of Certiorari to the Court of Appeal of California for the First Appellate District

BRIEF OF *AMICUS CURIAE* COMMITTEE ON STATE TAXATION IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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INTEREST OF THE AMICUS CURIAE

The Committee On State Taxation (COST) submits this brief as *amicus curiae* in support of Petitioner in the above captioned matter.[1] COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities. COST is a non-profit trade association that was organized in 1969 as an advisory committee to the Council of State Chambers of Commerce. COST, which was separately incorporated on January 1, 1992, has a membership of over 550 multistate corporations involved in interstate and international commerce.

COST submits this brief and believes this Court ought to grant certiorari because of California's inconsistent and incorrect application of the law; California's inability to decide upon a standard by which to apply the law; and, most importantly, because the issues presented by the instant case are currently being litigated in courts throughout the country without a clear, well-articulated touchstone regarding unitary theory. California courts have vacillated twice on the answer to this issue and have applied the result inconsistently to California taxpayers. The issue in this case is whether destination sales of a non-nexus affiliate may constitutionally be included in the numerator of the California apportionment factor. For 22 years, the standard in California (as stated in *Joyce*) was that non-nexus company receipts were not added into the "numerator." *Appeal of Joyce, Inc.*, No. 66-SBE-069 (Cal. St. Bd. of Equal., Nov. 23, 1966). *Finnegan II*[2]

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[1] No counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus curiae*, has made a monetary contribution to the preparation or submission of this brief. Written consent of Petitioner and Respondent has been obtained and filed with the Clerk of the Court.

[2] The decision is popularly known as *Finnegan II*. It was the opinion on rehearing from *Finnegan I*, 88-SBE-022 (Cal. St. Bd. of Equal., Aug.

repudiated the *Joyce* rule, thereby excluding the sales from the numerator, and remained the law for 9 years from 1990 to 1999. *Appeal of Finnegan Corp.*, No. 88-SBE-022-A (Cal. St. Bd. of Equal., Jan. 24, 1990). (*Finnegan* was formally adopted by California in Notice 90-3, dated June 8, 1990). Changing its mind again, the court in *Huffy* overturned *Finnegan*, restoring California to the old *Joyce* regime. *Appeal of Huffy Corp.*, No. 99-SBE-005-A (Cal. St. Bd. of Equal., Sept. 1, 1999).

This oscillation is exacerbated by the fashion in which California has implemented each change in position. The State applied *Finnegan* retroactively to taxpayers—but when *Huffy* was decided California chose to apply the reversal of position prospectively.[3] All of this occurred with *no* change in the underlying statute. It is this facet of the problem that has created the tax liability at issue in the instant case.[4] There is a need for a standard of uniformity in California. There is also a concomitant need for such a standard throughout the United States. Four other states currently follow *Finnegan*: Arizona, Indiana, Kansas and Utah.[5] New York is currently in litigation over which standard to apply. Many states,

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28, 1988), whose facts were the mirror-image of *Joyce*. It was not until 1990 that the SBE specifically overruled *Joyce*, although its logical underpinnings were unmoored by the SBE's 1988 decision.

[3] *Compare Appeal of Wynn's International*, No. 98R-0857 (Cal. St. Bd. of Equal., Sept. 1, 1999) and *Appeal of Nutrasweet Corp.*, No. 92-SBE-024 (Cal. St. Bd. of Equal., Oct. 29, 1992) (both applying *Finnegan* retroactively) *with Huffy* (stating that the return to *Joyce* applies only for tax years beginning on or after April 22, 1999).

[4] California assessed Citicorp using the *Finnegan* rule for years prior to the *Huffy* change in position.

[5] *Airborne Navigation Corp. v. Arizona Dept. of Rev.*, No. 395-85-I (Ariz. Bd. of Tax Appeals, Feb. 5 1987); Ind. Dept. of Rev. Information Bulletin No. 12, (Sept. 1 1988); Kan. Dept. of Rev. Ruling No. 12-91-1 (Feb. 1, 1991); Utah Reg., Rule R865-6F-24 (Nov. 24, 1993).

including Alaska, Colorado, Illinois, and Maine, have taken the position that *Joyce* is the proper standard.[6] Hence, there is not only a patent split of authority among the states but also the potential for repeated appeals through those court systems and ultimately before this Court. The granting of certiorari by this Court would resolve the current ambiguity and would provide judicial economy by foreclosing numerous possible future appeals.

SUMMARY OF THE ARGUMENT

COST asks this Court to accept the case and determine that California violated the Due Process and Commerce Clauses of the United States Constitution by taxing an entity with no constitutional nexus with the state. The inclusion of Petitioner's affiliate's California destination sales into both the numerator of California's apportionment factor and the apportionable tax base makes the end result the same as if California had subjected Petitioner's affiliate to income tax in the first place. The fact that Petitioner's affiliate is part of a unitary group subject to tax in California is relevant to whether the affiliate's income is included in the taxable base, but it does not support including the affiliate's sales in the numerator of the apportionment factor.

The unitary business principle is strictly a theory of apportionment. It was not meant to be a blanket rule of jurisdiction to tax. The fact that an entity is unitary with a group of entities does not, *a fortiori*, render the entity taxable in each state where the group has nexus. To reach such a conclusion is to transmute *unitary* theory into *nexus* theory. Stated alternatively, it is possible to have a unitary group

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[6] *In the Matter of Taxpayer Corp.*, No. 90-027 (Alaska Dept. of Rev., Sept. 17, 1990); Colo. Dept. of Rev. Bulletin No. 92-10 (July 1992); *Dover Corp. v. Illinois Dept. of Rev.*, 648 N.E.2d 1089 (Ill. App. Ct. 1995); *Great Northern Nekossa Corp. v. State Tax Assessor*, 675 A.2d 963 (Me. 1996).

where not all members have nexus with the taxing state. That is the situation in the instant case. In such a scenario, the proper logic is that *all* business income of the unitary group forms the apportionable tax base. However, all of that income is not automatically part of California's apportionment numerator used to form the portion to which California is entitled. Only those members of the unitary group who have proper Constitutional nexus with California have their factors included in California's numerator. To conclude otherwise renders the nexus concept nugatory as applied to a unitary group.

A clear example of California's use of unitary measurement as a replacement for nexus theory is useful. Assume the existence of three affiliated corporations, One, Two and Three, with daily operations so intertwined that they cannot be parsed out for tax purposes. California deems the three corporations a unitary group. Under this large umbrella, all business income of the group, as defined by UDITPA,[7] is to be apportioned based on the standard formula. The denominator of the formula, hence, includes the total sales generated by all three corporations. However, if only One and Two have nexus with California, then the numerator is only the sales of One and Two. Since Three has no nexus, it is not part of the numerator, only the denominator. Placing Three's California-sourced sales into the numerator, is the same as taxing Three in the first place, which violates Constitutional nexus safeguards. To eliminate Three's income from both the numerator and denominator results in Three's sales being apportioned based *only on* One

[7] UDITPA, the Uniform Division of Income for Tax Purposes Act, provides definitions of business and nonbusiness income and rules for the apportionment and allocation of income. Income is determined to be business income if it meets UDITPA's transactional or functional test and is then subject to apportionment. Income which is outside UDITPA's test is non-business income and is allocated in whole to one state, not divided per formulary apportionment.

and Two's factors. The only formulation that preserves unitary theory is to place Three's sales only in the denominator.

ARGUMENT

I. CALIFORNIA'S IMPROPER APPLICATION OF THE UNITARY BUSINESS PRINCIPLE RESULTS IN THE TAXATION OF CORPORATIONS OVER WHICH CALIFORNIA HAS NO CONSTITUTIONAL JURISDICTION.

Ostensibly the inquiry in this case need not go beyond the admission of the State of California that the tax rule complained of in this case has the result of taxing an entity that did not have nexus with the State. *See Huffy*. In considering its abandonment of the *Finnegan* rule, which the State would impose on the taxpayer in this case, the State Board of Equalization stated, "while there was hope that the *[Finnigan]* apportionment rule would lead to a truer application of the unitary concept, the actual practice has resulted in the taxation of corporations which would not otherwise be taxed as they have no tax nexus with the State of California." Id. (emphasis added). Your *amicus* realizes that confessed violations of the Due Process and Commerce Clauses of the United States Constitution alone may not be sufficient to warrant this Court's exercise of its discretion to decide this case, but that coupled with the continued use of the unconstitutional rule by other states is a compelling consideration.

1. The Unitary Business Principle, as articulated by this Court, is an application of the Due Process and Commerce Clauses' fair apportionment standards and thus cannot work to subject an entity to tax that does not otherwise have nexus.

This Court's approval of the unitary business principle is a recognition that under certain circumstances the business

activities of a commonly-owned and controlled group of entities may be so inextricably wound that the value or income of each of the entities may be more fairly measured as a part of their total income.[8] So the law allows tax jurisdictions to use the hypothetical construct of a unitary business to determine the overall scope of the economic enterprise that is to have its value or income measured for the purpose of assigning a portion to the state. The Court has set the guidelines for this determination in terms of centralized management, functional integration and economies of scale. *Mobil Oil Corp. v. Commissioner of Taxes of Vermont*, 445 U.S. 425 (1980). The focus of the inquiry is on how a business operates within itself.

To prevent multiple and extraterritorial taxation, a taxpayer has a constitutional right to a division of the tax base between those states where the taxpayer is subject to jurisdiction. *Standard Oil Co. v. Peck*, 342 U.S. 382 (1952). UDITPA was enacted by California and other states to promote uniformity among the states in how they divide the tax base. UDITPA § 19. CAL. REV. & TAX CODE §§ 25120–25139. The part of the total income that is assigned to an entity in a particular jurisdiction is determined by formula apportionment. That is, the factors of business activity that generate the value or income in each of the jurisdictions in which it does business are measured and the value or income of the business is assigned to those jurisdictions in proportion to the factors that exist in those jurisdictions. So, for example, a typical manufacturing business may have its income apportioned by use of the three-factor formula of payroll, property and sales; a pipeline company may have its income apportioned in accord with a barrel-miles formula; and a shipping company may have its income assigned by use of a ton-miles formula. The particulars may vary from one

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[8] *See Pullman's Palace Car Co. v. Pennsylvania*, 141 U.S. 18 (1891); *Western Union Tel. Co. v. Taggart*, 163 U.S. 1 (1896).

type of business to the other, but this is essentially a measuring exercise.

The apportionment formula used in California is a standard,[9] three-factor formula of payroll, property and sales.[10] The kernel issue before this Court is exactly what constitutes the proper numerator in the sales factor. *Finnegan* and the California lower courts would believe that the "sales within California" are all of those conducted by the entire unitary group. Petitioner and *amicus* contend that the "sales within California" can only include the sales of those members of the unitary group that have nexus with California.

Nexus principles dictate that a state can only exert income tax jurisdiction when it is constitutional to do so. *Complete Auto Transit v. Brady*, 430 U.S. 274 (1977). Both Commerce Clause and Due Process Clause nexus must be met. U.S. CONST. art. I, § 8, cl .3; U.S. CONST. amend. XIV, § 1. Thus, any application of UDITPA formulary apportionment is bound by Constitutional nexus limitations. The unitary business principle (what is to be measured), and formula apportionment (how much of the thing measured is assigned to what entity in what jurisdiction), are tools of measurement. They are not determinative of who is taxable where. This last consideration, nexus, is determined on the basis of the amount and types of activity that an entity has within the taxing jurisdiction.

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[9] California double-weights the sales factor in computing the average. CAL. REV. & TAX CODE § 25128(a).

[10] This formula has been upheld as Constitutional. *See Container Corp. of America v. Franchise Tax Bd.*, 463 U.S. 159 (1983).

2. The inclusion of the California-destination sales of the Petitioner's affiliate, which has no nexus with the state, in the numerator of California's receipts factor for purposes of apportioning Petitioner's income changes the Unitary Business Principle from a principle of measurement (apportionment) to one of jurisdiction (nexus).

The Petitioner is part of a unitary group that has activity in California. Within this unitary group are entities that have nexus with California and, in particular, one without nexus—the South Dakota affiliate, Citibank, S.D.[11] However, that same entity has sales receipts arising from transactions destined for California. There are three alternatives as to what should be done with the California sales of Citibank S.D. The first option is to include the sales in neither the numerator nor the denominator of the apportionment formula.[12] Alternatively, the income could be added to both the numerator and denominator. The third, and proper treatment is to place the California sales income into only the denominator of the formula, not the numerator.

The denominator relates to factors of production that created the total unitary group's income. *Cf. Adams Express Co. v. Ohio*, 165 U.S. 194, 221 (1897) (stating that the 'unit' being measured was one "of use and management."). The Unitary Business Principle grew from the railroad cases that treated the entire enterprise as a single "unit" of business. Applying this same methodology to the instant case, all business income by the Petitioner's unitary group is included as the units' total income and included in the denominator.

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[11] As stipulated by both Petitioner and Respondent. Joint Stipulation ("Stip") ¶ 19, Joint Appendix filed with the Cal. Ct. App. ("JA") p. JA 0099.

[12] Although not espoused by either party, this formulation is incorrect as it equates unity to nexus. The practical result is that the excision of the sales from the denominator turns the income into either allowable non-business income or says that Citibank S.D. is not part of the unitary group.

The numerator only relates to activity constitutionally related to the taxing state. *See* CAL. REV. & TAX CODE § 25134. Under Constitutional nexus rules, that activity cannot be unilaterally "sourced" to the state. There must be an underlying nexus between the taxing state and the entity that generated the activity taking place from sources within. *See Complete Auto Transit*, 430 U.S. at 277–79. The basis for establishing this connection is solely nexus theory, not unity. The Unitary Business Principle was never intended to be a proxy for substantial nexus. *Cf. Shell Oil Co. v. Iowa Dep't of Rev.*, 488 U.S. 19, 31 (1988) (stating "the function of an apportionment formula is to determine the portion of a unitary business' income that can be fairly attributed to in-state activities"). Moreover, to impute a connection based upon unity fails in practical application by overextending the tax authority of the State—the majority of states do not treat unity and nexus as equipollent systems.

The nostrum both *Finnegan* and Respondent proffer as the solution—the inclusion of the California sales in both the numerator and denominator—yields the same practical result as if Citibank S.D. had been taxed in its own right to begin with. Such a result contravenes the entire premise of nexus. It allows California to do indirectly what it otherwise is constitutionally prohibited from doing. *Hunt-Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458, 468 (2000). Within the unitary group, some members have nexus with California and some do not. If all members' sales income is included in the numerator, then the result is that each one is effectively treated as if it had nexus with California. The ramifications are such that each member of the unitary group can then be said to have nexus in each state where any one of the group's members has nexus. This formulation expands taxing authority beyond the bounds of traditional nexus principles by allowing a State to tax an entity that has no connection to the taxing state but for being unitary with another entity that does.

A simple example following the facts of this case illustrates the difference between measurement and nexus. A single corporation, A, doing business in South Dakota, may make sales into California. If A has all of its property and payroll in South Dakota and makes 30% of its sales to California destinations, the typical three-factor formula would assign 10% of A's sales to California.[13] However, A may not have sufficient contacts with California that California may tax the income of A. If the South Dakota corporation present in this case were not a part of a unitary group of corporations it is agreed that there would be no tax due from it.

In the case before the Court, the South Dakota corporation, ("A" for convenience), is a member of a unitary group of corporations. Should that change the result? California concedes that A is not taxable in California, but would use A's sales nevertheless to attract tax to California.

The correct solution is that the California sales of Citibank S.D. are properly includible in the denominator but should not be part of the numerator. The numerator, as it represents the activity within California of the taxpayer, can only be that activity that has nexus between California and the taxpayer. *Complete Auto,* 430 U.S. at 277. The criticism of the *Joyce/Huffy* standard is that it allows for corporate form to prevail over economic substance, given that a different result is reached if corporate divisions, rather than separate entities are used.[14] The countervailing problem is that the *Finnegan* standard requires mutating the Unitary Business Principle into one of nexus and, at the same time, overriding the United States Constitution's constraints on the power of California to impose corporate income taxes. The better reasoned

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[13] Calculated as follows: (0/100 + 0/100 + 30/100 = 30/300 = 10%).

[14] But this criticism is inadequate. *Amicus* and Petitioner believe that a slight asymmetry between form and substance is preferable to an unconstitutional application of unitary theory.

resolution is to reverse the California Court of Appeals and find that California sales income can only include those members of the unitary group which have actual nexus with the state.

CONCLUSION

For the reasons stated above, and because this critical issue is spreading to other states, COST respectfully requests the Court to accept this case for review, reverse the decision below and order a refund of the tax involved.

Respectfully submitted,

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(4)

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No. 00-1537

In The

Supreme Court of the United States

CITICORP NORTH AMERICA, INC. & AFFILIATES,

Petitioners,

v.

FRANCHISE TAX BOARD,

Respondent.

On Petition For A Writ Of Certiorari To The Court Of Appeal Of California For The First Appellate District

REPLY BRIEF FOR PETITIONERS

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RULE 29.6 STATEMENT

Petitioner Citicorp North America, Inc. is a wholly-owned subsidiary of Citicorp, which is a wholly-owned subsidiary of Citigroup Holdings, Inc., which is a wholly-owned subsidiary of Citigroup, Inc. Citigroup, Inc. is a publicly-held corporation.

During the 1985-1988 years in issue, the ownership of petitioner Citicorp North America, Inc. was as follows: During 1985-1987, petitioner Citicorp North America, Inc. and its predecessors (Citicorp Industrial Credit, Inc. and Citicorp (USA), Inc.) were wholly-owned subsidiaries of Citicorp Banking Corporation, which was a wholly-owned subsidiary of Citicorp. During 1988, petitioner Citicorp North America, Inc. was a wholly-owned subsidiary of Citicorp. Citicorp was a publicly-held corporation during all of 1985-1988.

Affiliates of petitioner Citicorp North America, Inc., who were California taxpayers during the 1985-1988 years in issue, as listed in the Appendix pages 102a-104a, were wholly-owned (directly or indirectly) by petitioner Citicorp North America, Inc. or its ultimate parent, Citicorp, during the 1985-1988 years in issue.

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REPLY BRIEF FOR PETITIONERS

Respondent essentially makes three points in its Brief in Opposition. First, it contends the case lacks ongoing national significance because California has since changed, on a prospective basis, the tax scheme at issue here. Brief in Opposition to Petition for Writ of Certiorari ("Br. Opp.") 11-12. Second, it contends this Court has already determined that subjecting the income of a unitary group to apportionment does not result in the taxation of extraterritorial income. Br. Opp. 12. Third, it contends that because California's method of taxation in this case apportions income to California in a fair manner, neither the anti-discrimination requirement nor the fair apportionment requirement of the Commerce Clause is implicated. Br. Opp. 21-25.

None of these points has merit. First, it is not true that issues raised here have "no ongoing legal significance in California." Br. Opp. 11. While it is indeed true that respondent recently amended the rules at issue here, it did so on a *prospective* basis. Thus, in addition to petitioner, other taxpayers in California face the same issue here on audit and in litigation. More importantly, however, is the ongoing *national* significance of the rule announced by the lower court. Four other States currently follow California's position in this case, and the lower court's opinion could embolden California to revert to its former position and other States to follow California's rule.

Second, respondent's attempt to cast this case as a challenge to the unitary or formula apportionment method ignores petitioner's central contention – that the State cannot arbitrarily shift income among corporations, by taking the California activities of nontaxable corporations and using them to assign income to taxable corporations, all under the guise of simply declaring all the corporations "unitary." Yet, this is precisely what respondent argues to this Court.

Third, respondent's rebuttal to petitioner's discrimination and fair apportionment claims disregards this Court's controlling Commerce Clause doctrine, and fails to respond to the incontrovertible fact that respondent's method of determining taxable income penalizes a corporation with affiliates that are *not* taxable by California and taxes petitioner on income that bears no relation to its (*i.e.*, the California taxpayer's) activities in the State.

In short, as we demonstrate below, an analysis of respondent's Brief in Opposition reinforces the case for granting a writ of certiorari.

I. THIS CASE HAS PROFOUND NATIONAL SIGNIFICANCE

Respondent's contention that this case "lacks sufficient importance" is without merit. Br. Opp. 13. The lower court's decision upholds a mechanism for determining a corporation's taxable income that allows California to shift income from a nontaxable affiliate to a taxable one – all under the guise of simply calling the corporations "unitary." The court's decision extends well beyond California to all States that impose a corporate income tax on a unitary basis. The decision allows respondent to tax the income of a nontaxable corporation engaged in a unitary business by shifting such income to an affiliate that is taxable. In effect, the rule established by the lower court is one of far-reaching import: once income has been properly apportioned to a State, the State is free to tax 100 percent of such income, even where a part of that income is attributable to a corporation that is not taxable and where in-state activities of a nontaxable corporation are used to assign income to a taxable corporation. Thus, even where a State cannot directly tax a nontaxable corporation, under the lower court's decision a State would be able to tax that corporation's income through the simple device of shifting the income to a taxable affiliate.

Moreover, there is no merit to respondent's contention that the lower court's decision is not a serious threat to constitutional restraints on state taxation. Br. Opp. 13-14. On the contrary, the decision nullifies the axiomatic principle of taxation that a State may not tax a person on income earned by another:

> We have no doubt that, because of the fundamental conceptions which underlie our system, any attempt by a state to measure the tax on one person's property or income by reference to the property or income of another is contrary to due process of law as guaranteed by the Fourteenth Amendment. That which is not in fact the taxpayer's income cannot be made such by calling it income.

Hoeper v. Tax Comm'n, 284 U.S. 206, 215 (1931).

Finally, respondent's attempt to minimize the national significance of this case is belied by the sheer number of court and administrative decisions from around the country that have considered the issues raised here,[1] and by the extraordinary interest this case has garnered among state tax practitioners and academics. Petition for a Writ of Certiorari ("Pet.") 24 n.9. In sum, the issues presented in this case are, and continue to be, truly "national" issues with profound ramifications upon the

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[1] *See, e.g., In re Taxpayer Corp.*, No. 90-027, Caseload No. 89261, 1990 Alas. Tax LEXIS 22 (Alaska Dep't of Rev., Sept. 17, 1990) (supporting petitioner's position); *Dover Corp. v. Department of Rev.*, 648 N.E.2d 1089, *appeal denied*, 657 N.E.2d 618 (Ill. App. 1995) (to the same effect); *Great N. Nekoosa Corp. v. State Tax Assessor*, 675 A.2d 963 (Me. 1996) (to the same effect); *In re Silver King Broad. of N.J., Inc.*, 1995 N.Y. Tax LEXIS 425 (N.Y.S. Div. of Tax App., Aug. 10, 1995) (to the same effect); *Emerson Elec. Co. v. Wasson*, 339 S.E.2d 118 (S.C. 1986) (to the same effect); *but see Airborne Navigation Corp. v. Arizona Dep't of Rev.*, No. 395-85-I, 1987 Ariz. Tax LEXIS 34 (Bd. of Tax App., Feb. 5, 1987) (supporting respondent's position).

manner in which states tax the income and activities of multistate taxable (and nontaxable) corporations.

II. CASES UPHOLDING THE UNITARY OR FORMULA APPORTIONMENT METHOD HAVE NO BEARING ON THE ISSUES RAISED HERE

Much of respondent's brief is devoted to the undisputed proposition that the unitary or formula apportionment method has long been upheld against challenges that it indirectly taxes extraterritorial income. Br. Opp. 14-16, 18-21. Respondent's goal in redirecting the inquiry is transparent: it seeks to place itself under the umbrella of this Court's decisions that have affirmed the settled proposition that including income of a unitary group in the preapportionment tax base does not constitute taxation of such income and that have affirmed the equally settled proposition that the use of formula apportionment methods is a valid method of determining income attributable to a State in light of the difficulty of ascertaining precisely what share of a unitary business's income should be apportioned to a State. However, as pointed out in the Petition and again below, neither the "unitary method" nor the preapportionment tax base is an issue in this case. The issues in this case surround respondent's claims it can tax income of a nontaxable corporation.

Respondent relies upon *Shell Oil Co. v. Iowa Dep't of Rev.*, 488 U.S. 19 (1988), and *Moorman Mfg. Co. v. Bair*, 437 U.S. 267 (1978). Br. Opp. 14-16, 18. However, respondent misreads *Shell Oil*, *Moorman*, and the other cases cited in its brief as supporting respondent's arbitrary reassignment of nontaxable income to petitioner. There is *no* dispute that income of Citibank (South Dakota), N.A. may be included in the preapportionment tax base, and there is *no* dispute that the three-factor formula employed by California apportions income that is related to the unitary group's activities in California. The issue here, however, is whether California can tax 100 percent of the income apportioned to this State when it is clear that

some of that *apportioned* income is attributable to a corporation that was immune from taxation. In other words, does the mere apportionment of income to a State give that State license to tax that income, or is the State required to determine whether it can tax that income after it is apportioned to the State? This is the fundamental question presented by this case, and that question has never been considered by this Court – in *Shell, Moorman,* or elsewhere.

The unitary method of taxation essentially involves a four-step process: first, the members of the unitary group are determined (Step One); second, the apportionable income of the unitary group is combined into a single "pot" of apportionable income (Step Two); third, an apportionment formula is applied to the "pot" of apportionable income to determine the income attributable to a particular State (Step Three); and fourth, the apportioned income is then assigned to the individual taxpayer entities producing that income (Step Four).

The cases cited by respondent address only the first three steps – who can be included in the unitary group (Step One) (Br. Opp. 14, *citing, e.g., Barclays Bank PLC v. Franchise Tax Bd. of Cal.*, 512 U.S. 298 (1994)); what income may be included in the pot to be apportioned among the States (Step Two) (Br. Opp. 15-16, *quoting Shell Oil Co.*, 488 U.S. 19); or the constitutionality of the apportionment formula (Step Three) (Br. Opp. 18, *quoting Moorman Mfg. Co.*, 437 U.S. 267). Specifically, respondent quotes from *Shell Oil Co.*, 488 U.S. at 30-31: "But income that is included in the preapportionment tax base is not, by virtue of that inclusion, taxed by the state" (Br. Opp. 15), and from *Moorman Mfg. Co.*, 437 U.S. at 273: "This method [unitary business formula apportionment] . . . is employed as a rough approximation of a corporation's income that is reasonably related to the activities conducted within the taxing State." Br. Opp. 18. The quoted language, however, simply has no bearing on the issues presented here. Respondent reads far too much into those

cases, declaring that *Shell Oil Co.* "implicitly" supports the income shift at issue here. Br. Opp. 16. *Shell Oil Co.* (as well as the other cases cited by respondent upholding the inclusion of nontaxable income in the preapportionment tax base) never implicitly (or even explicitly) considered the fundamental issue presented here, which is whether a State may tax income that is properly apportionable to California, but that is directly attributable to a corporation outside California's taxing jurisdiction. Thus, the authorities relied upon by respondent provide no support for its position in this case.

The arbitrary shifting of income in this case occurs in Step Four, after the unitary group's income has been apportioned to California. Under Step Four, if all corporations with California activities are taxable by the State, California assigns the apportioned income to each corporation on a pro rata basis. *See* Cal. Franchise Tax Bd., Legal Ruling No. 234, [1955-1959 Transfer Binder] Cal. Tax Rptr. (CCH) ¶ 201-418 (Oct. 27, 1959).[2]

However, if, as here, a corporation with California activities is *not* taxable by California, California then arbitrarily shifts that corporation's income to the other *taxable* corporations. *See* Cal. Franchise Tax Bd., Notice No. 90-3, [1991-1992 Transfer Binder] Cal. Tax Rptr. (CCH) ¶ 410-820 (June 8, 1990) (reproduced at App. 86a). It is this shifting of income that is the core issue in this case and that finds no support or justification in respondent's brief.

In sum, respondent's method of assigning income violates two core principles of taxation. First, it is well established that a State cannot tax through indirect means that which it cannot tax through direct means, *see, e.g., Passenger Cases*, 48 U.S. 283 (1849); *Hunt Wesson, Inc. v. Franchise Tax Bd.*, 528 U.S. 458 (2000). Second, it is equally

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[2] This ruling is available on respondent's website at http://www.ftb.ca.gov/legal/rulings/active/lr234.htm (as of June 6, 2001).

well established that a State may not tax a person or corporation on the income of another. *Hoeper*, 284 U.S. 206. Respondent has provided no effective rebuttal to these points.

III. RESPONDENT'S CONTENTIONS THAT THE TAX SCHEME AT ISSUE HERE DOES NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE AND IS FAIRLY APPORTIONED ARE UNPERSUASIVE

A. Respondent Has Offered No Effective Rebuttal in Support of Its Discriminatory Tax Scheme

Respondent's primary defense against petitioner's assertion that its tax scheme discriminates against interstate commerce is that petitioner "ignores fundamental principles of combined reporting and reverts to the separate accounting principles which this Court has previously rejected." Br. Opp. 21. This rebuttal is wholly without merit, and is rather confusing.

First, "separate accounting" is not and never has been an issue in this case, because petitioner has never alleged that separate accounting principles should be used in this case. Indeed, petitioner prepared the returns at issue based on the unitary method. Respondent's rebuttal again demonstrates its attempt to redirect this Court's attention from the central issue in this case. Again, the central issue in this case is whether respondent can take income that has been apportioned to California and assign it all to taxable corporations, even though a part of such income is directly attributable to the California activities of a nontaxable corporation. This issue has no relation to separate accounting.

Second, respondent misconstrues unitary theory as permitting it to treat the unitary group as a single taxpayer rather than as merely a method of determining the income of each individual member of the unitary group. In this regard, respondent declares: "the *tax liability of a*

group of corporations engaged in a unitary business both within and without the state is appropriately measured not by reference only to the taxable status of individual members of the unitary business, but rather, by reference to the activities of the entire unitary group . . . . " Opp. Br. 22 (emphasis added). Respondent errs by assuming that unitary theory allows it to determine taxable income on a group basis. On the contrary, respondent's conception of unitary theory is directly at odds with the settled purpose of unitary taxation – *i.e.*, to determine the income attributable to a particular State. As the California Supreme Court observed, unitary theory "is not necessarily a disregard of the corporate entity nor an extension of the provisions of the statute by implication. Formula allocation is merely a method of ascertaining the true income attributable to the plaintiff's business." *Edison Cal. Stores v. McColgan*, 30 Cal. 2d 472, 481 (1947). Rather than providing a basis for respondent to tax the unitary group as if it were a single taxpayer, unitary theory is merely the means by which the income of a unitary group is divided among the States in which it does business. Unitary theory does not speak to whether a State can tax such income once it is apportioned, which is the issue here. Nor does unitary theory determine who is a "taxpayer."

Third, respondent's superficial attempt to distinguish *Fulton Corp. v. Faulkner*, 516 U.S. 325 (1996), is also unavailing. Respondent contends that *Fulton* is not relevant because the "state taxing scheme condemned in that case did not arise in the context of the apportionment of income of a unitary business . . . . " Br. Opp. 22. Respondent apparently suggests that discrimination is acceptable as long as it arises in the context of an apportioned tax. Indeed, respondent confirms this by quoting, out of context, this Court's statement from *Container Corp. v. Franchise Tax Bd.*, 463 U.S. 159, 171 (1983), "[a]t least in the interstate commerce context . . . the anti-discrimination principle has not in practice required much in addition to the requirement of fair apportionment." Br. Opp. 23.

There is no substance to respondent's assertion on this point. In *Westinghouse Elec. Corp. v. Tully*, 466 U.S. 388, 399 (1984), the Court observed that " '[f]airly apportioned' and 'non-discriminatory' are not synonymous terms" in striking down a fairly apportioned New York income tax that was, nevertheless, unconstitutionally discriminatory. Indeed, the Court has flatly declared that "[e]ven if a tax is fairly apportioned, it may discriminate against interstate commerce." *Amerada Hess Corp. v. Director, Div. of Taxation*, 490 U.S. 66, 75 (1989).

Nor does respondent advance the analysis by suggesting that "when this apportionment method was applied to 'outbound sales,' it actually had the effect of *reducing* the income base of the taxable members of the group taxable in California." Br. Opp. 22. This observation is irrelevant to the question before this Court. Simply because the tax scheme at issue here treats taxpayers favorably in certain situations has no bearing on the question presented here where taxpayers are not treated favorably – whether the tax scheme penalizes petitioner for affiliating with corporations that engage in limited activities in California, and therefore are not taxable by the State.

B. Likewise, "Fair Apportionment" Is No Defense to the Constitutionality of the FTB's Method of Arbitrarily Reassigning Exempt Income

Once again, respondent bases its rebuttal on the contention that petitioner's case is founded on separate accounting principles: "[B]y attempting to attach income and apportionment factors to individual members of an integrated unitary business enterprise, Citicorp inappropriately injects separate accounting principles into the apportionment process." Br. Opp. 23. As discussed above, this contention is false and must be dismissed.

Respondent's arbitrary shifting of income from a nontaxable corporation to a taxable corporation cannot be saved by asserting that California has employed a fairly

apportioned tax scheme. It is not the isolated apportionment of income to California that implicates the Constitution here, but rather respondent's subsequent arbitrary shifting of the California income from nontaxable to taxable corporations. As a result of this shifting of income, the income assigned to petitioner does not "reflect a reasonable sense of how [petitioner's] income is generated." *See Container Corp.*, 463 U.S. at 169. The amount of income arbitrarily assigned to petitioner is completely unrelated to the extent of its activities in the State. The point to remember here is that respondent's method *increased* the tax liability on *all* the members of petitioner's unitary group which were California *taxpayers*, yet *none* of those California taxpayers' activities in California increased at all. The tax increase is due directly to respondent taking income attributable to the California activities of a nontaxable member of the unitary group (*i.e.*, Citibank South Dakota) and assigning that income to *California* taxpayers.

CONCLUSION

For the reasons set forth above, the petition for certiorari should be granted.

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No. 00-1537

In the Supreme Court of the United States

Citicorp North America, Inc. & Affiliates,
Petitioner,

v.

Franchise Tax Board,
Respondent.

On Petition for Writ of Certiorari to the Court of Appeal of California for the First Appellate District

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Motion for Leave to File Out of Time Brief of *Amicus Curiae*
Committee On State Taxation
In Support of Petition for Writ of Certiorari

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The Committee On State Taxation (COST)[1] requests leave to file out of time a brief *amicus curiae* in support of Citicorp's Petition for Writ of Certiorari. COST respectively requests this Court to grant this motion because: a) COST was not accurately informed as to the extended due date of the Respondent's brief; b) COST has extensive experience in state tax issues which can aid this Court in reviewing the issue; and c) COST's brief represents the views of many multistate corporate taxpayers and in a short, direct form compliments the Petitioner's brief. COST's proposed brief is attached. Counsel for both the Petitioner and the Respondent have consented to the filing of this brief (written permission attached).

COST became aware of Citicorp's Petition for Certiorari approximately two weeks before May 6, 2001, the initial date that an *amicus* brief in support of the Petitioner would have been due in this case. The Petition for Certiorari was filed April 6, 2001. COST has a small staff (three full-time attorneys) and was initially concerned about its ability to finalize a brief in such a short time period. However, shortly thereafter COST was informed that the Respondent intended to file a motion for a 30 day extension, and it was COST's understanding that such an extension would revise any due date to June 6, 2001. As a result, COST determined that it had the staff and time resources to complete the brief. COST created an initial draft of the brief and arranged to send the brief to the printer on June 3, 2001. On June 1, 2001, however, COST staff discovered through conversations with the attorney for the Petitioner, that the Respondent's request for a 30 day extension had not been fully granted by this Court, and that the Respondent's due date had been set as May 30, 2001. As a result, COST was not able to timely file its *amicus* brief. COST immediately notified the clerk's office of the problem. Because of the confusion over the actual due date, COST asks that this Court accept its brief filed out of time.

COST believes that this Court's deliberations would be enhanced by COST's involvement because of COST's extensive experience in the state tax area. COST has filed numerous *amicus* briefs with this Court[2] in cases that COST believes are of national importance to multistate taxpayers and need

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[1] COST is a non-profit trade association, organized in 1969 with a membership of over 550 multistate corporations involved in interstate and international commerce. COST's objective is to preserve and promote equitable and nondiscriminatory state and local taxation of multi-jurisdictional business entities.

[2] *Newsweek, Inc. v. Department of Revenue of the State of Florida; General Motors Corporation v. Roger W. Tracy, Tax Commissioner of Ohio; Barclays Bank PLC v. Franchise Tax Board and Colgate-Palmolive*

judicial resolution at the highest level. Further, COST, as an organization, is dedicated to the education and advocacy of state tax issues and its staff and members spend considerable time analyzing the legal and policy issues related to this area.

Finally, COST notes that its brief complements the Petitioner's brief without adding unnecessary and burdensome repetition. COST's brief succinctly summarizes the issue involved and its affect on interstate corporate taxpayers.

Because of these extraordinary circumstances, COST respectfully requests that this Court accept COST's brief *amicus curiae* in support of Citicorp's Petition for Writ of Certiorari, as filed.

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Company v. Franchise Tax Board; Reich v. Collins; Geoffrey, Inc. v. South Carolina Department of Revenue and Taxation; The Kroger Co. v. The Kansas Department of Revenue; Gladwin Corp., v. Michael L. Patterson; South Central Bell Telephone Company, et al. v. State of Alabama; Topps Company v. Revenue Division of the Court of Claims Department of Treasury; Caterpillar Inc., v. The New Hampshire Department of Revenue Administration; Hunt - Wesson, Inc. v. Franchise Tax Board.